



Making Credit Safer

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MAKING CREDIT SAFER

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Physical products, from toasters and lawnmowers, to infant car seats and toys, to meat and drugs, are routinely inspected and regulated for safety. Credit products, like mortgage loans and credit cards, on the other hand, are left largely unregulated, even though they can also be unsafe. Because financial products are analyzed through a contract paradigm rather than a products paradigm, consumers have been left with unsafe credit products. These dangerous products can lead to financial distress, bankruptcy, and foreclosure, and, as evidenced by the recent subprime crisis, they can have devastating effects on communities and on the economy. In this Article, we use the physical products analogy to build a case, supported by both theory and data, for com-

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prehensive safety regulation of consumer credit. We then examine the present state of consumer credit regulation, explaining why the current regulatory regime has systematically failed to provide meaningful safety regulations. We propose a fundamental restructuring of this regime, urging the creation of a new federal regulator that will have both the authority and the incentives to police the safety of consumer credit products.

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INTRODUCTION

Safety regulation is everywhere. Toasters, lawnmowers, infant car seats, toys, meat, drugs, and many other physical products are routinely inspected and regulated for safety. Indeed, regulation of such products has become so firmly woven into the marketplace that it is headline news when regulators fail to prevent a dangerous product from making it into the hands of consumers. No one asks if such items should be regulated; policy discussions center instead on whether such regulation is adequate.

Consumer credit products also pose safety risks for customers. Credit cards, subprime mortgages, and payday loans can lead to financial distress, bankruptcy, and foreclosure. Economic losses can be imposed on innocent third parties, including neighbors of foreclosed property, and widespread economic instability may affect economic growth and job prospects for millions of families that never took on a risky financial instrument. Financial harm is not the same as physical harm, but it can be as real and as painful. Why are consumers protected from dangerous products and sharp business practices when they purchase tangible consumer products, but left at the mercy of

their creditors when they sign up for routine financial products like mortgages and credit cards?¹

The difference between the two markets is regulation. Although the “R-word” is considered an epithet in many circles, regulation supports a booming market in tangible consumer goods. Nearly every product sold in America has passed basic safety regulations well in advance of being stocked on store shelves.² Credit products, by comparison, are weakly regulated by a tattered patchwork of federal and state laws that have failed to adapt to changing markets. Thanks to effective regulation, innovation in the market for physical products has

¹ Our identification of financial consumer products as a subcategory of consumer products mirrors the well-known argument about the collapse of the contract-product distinction. See generally Douglas G. Baird, *The Boilerplate Puzzle*, 104 MICH. L. REV. 933 (2006) (analyzing boilerplate and fine print language as components and attributes of products); Arthur Allen Leff, *Contract as Thing*, 19 AM. U. L. REV. 131, 144–51, 155 (1970) (arguing in favor of recognizing the contract not merely as the result of a process, but as part of the product); Lewis A. Kornhauser, Comment, *Unconscionability in Standard Forms*, 64 CAL. L. REV. 1151 (1976) (recommending a legislatively imposed measure of unconscionability that looks to a contract’s resultant terms, not merely defects in the contracting process). The contract-product distinction also has been challenged in the consumer credit context. See John A. E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 405, 407–08 (2007) (proposing a products liability approach to financial products). In this Article we focus on consumer credit products, but most of our arguments and conclusions can be extended to other financial consumer products, including insurance and investment products.

² See Robert S. Adler, *Redesigning People Versus Redesigning Products: The Consumer Product Safety Commission Addresses Product Misuse*, 11 J.L. & POL. 79, 82–83 (1995) (chronicling the rise of the regulation of consumer products in reaction to “substantial numbers of unreasonably dangerous products circulated in virtually unregulated fashion throughout the country”); FTC, A Brief Overview of the Federal Trade Commission’s Investigative and Law Enforcement Authority, <http://www.ftc.gov/ogc/brfovrw.shtm> (last visited Oct. 1, 2008) (reviewing FTC regulatory authority over “unfair or deceptive acts or practices” which “cause[] or [are] likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition” (quoting 15 U.S.C. § 45(n) (2006)) (alterations in original) (emphasis omitted)); U.S. Consumer Product Safety Commission, CPSC Home Page—About Tab, <http://www.cpsc.gov/about/about.html> (last visited Oct. 1, 2008) (“The U.S. Consumer Product Safety Commission is charged with protecting the public from unreasonable risks of serious injury or death from more than 15,000 types of consumer products under the agency’s jurisdiction. . . . The CPSC’s work to ensure the safety of consumer products—such as toys, cribs, power tools, cigarette lighters, and household chemicals—contributed significantly to the 30 percent decline in the rate of deaths and injuries associated with consumer products over the past 30 years.”); U.S. Food and Drug Administration, What FDA Regulates, <http://www.fda.gov/comments/regs.html> (last visited Oct. 1, 2008) (“FDA is the federal agency responsible for ensuring that foods are safe, wholesome and sanitary; human and veterinary drugs, biological products, and medical devices are safe and effective; cosmetics are safe; and electronic products that emit radiation are safe.”).

led to greater safety and more consumer-friendly features. By comparison, innovation in financial products has produced incomprehensible terms and sharp practices that hurt consumers and reduce social welfare.

Credit has provided substantial value for millions of households, permitting the purchase of homes that help families accumulate wealth and cars that can expand job opportunities. Credit can also provide a critical safety net, permitting families to borrow against a better tomorrow if they suffer job layoffs, medical problems, or family breakups today. Many financial products are offered on fair terms that benefit both seller and customer.

For a growing number of families that are steered into overpriced and misleading credit products, however, credit products benefit only the lenders. For families that get tangled up with truly dangerous financial products, the results can be wiped-out savings, lost homes, higher costs for car insurance, denial of jobs, troubled marriages, bleak retirements, and broken lives.³

³ On the effects of credit card debt, see, for example, RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS ch. 15 (2006); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT ch. 4 (2000). On the effect of predatory lending on military personnel, see, for example, DEP'T OF DEF., REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS 39-42 (2006), available at <http://www.responsiblelending.org/issues/payday/reports/page.jsp?itemID=29862306> [hereinafter DOD, REPORT ON PREDATORY LENDING], which recounts select profiles from 3393 case studies of service members trapped in high-cost loans—the financial consequences of which were contributing factors to serious military disciplinary actions, including loss of promotion and separation from the military, lawsuits, bankruptcy, divorce, and impact upon other financial circumstances, such as exorbitant fees, necessitating further loans or home refinancing. On the effect of subprime mortgage products, see, for example, JOINT ECON. COMM., 2007 JOINT ECONOMIC REPORT 37-44 [hereinafter JEC REPORT], which concludes that a subprime foreclosure results in “loss of a stable living place and significant portion of wealth,” “create[s] possible tax liabilities,” and “reduces the homeowner’s credit rating, creating barriers to future home purchases and even rentals.” See also Editorial, *Losing Homes and Neighborhoods*, N.Y. TIMES, Apr. 10, 2007, at A20 (noting that “more than 500,000 . . . subprime borrowers have lost their homes to foreclosures” and that “some [of these families] may never recover”). On the effects of payday loans, see, for example, Erik Eckholm, *Seductively Easy, ‘Payday Loans’ Often Snowball*, N.Y. TIMES, Dec. 23, 2006, at A1, which asserts that impoverished populations, minorities, and military personnel are targeted by predatory lending and trapped by payday loans they cannot repay. On the effects of credit cards, see, for example, Moon Ihlwan, *Falling Madly in Love With Plastic: Is Korea’s Credit-Card Binge a Disaster Waiting to Happen?*, BUS. WK. (INT’L ED.), May 13, 2002, at 57, depicting students who have resorted to criminal behavior to pay off their credit card debt; Clarissa Segovia, *Watch Out for the Black Hole of Credit Card Debt*, ONLINE FORTY-NINER, Aug. 30, 2004, <http://www.csulb.edu/~d49er/>

In this Article we argue for parity of treatment between ordinary physical products and financial products that are sold to consumers. Credit products should be thought of as products, like toasters and lawnmowers, and their sale should meet minimum safety standards.⁴ We harness both theory and data to demonstrate that sellers of credit products have learned to exploit the lack of information and cognitive limitations of consumers in ways that put consumers' economic security at risk, turning them into far more dangerous products than they need to be. We argue that consumers are no better equipped to protect themselves from many common credit products than they were from poorly wired toasters or badly designed lawnmowers that started fires or sliced off fingers before the safety of these physical products was regulated. We also argue that the current legal structure, a loose amalgam of common law, statutory prohibitions, and regulatory-agency oversight, is structurally incapable of providing effective protection. We propose the creation of a single regulatory body that will be responsible for evaluating the safety of consumer credit products and policing any features that are designed to trick, trap, or otherwise fool the consumers who use them.

Despite the benefits that it provides, the market for consumer financial products suffers from deficiencies that prevent even intense competition from maximizing both consumer and social welfare. Rhetoric to the contrary notwithstanding,⁵ a careful examination of the market for financial products illustrates the need for systemic

archives/2004/fall/news/volLVno2-debt.shtml, noting that students have committed suicide from the pressures of credit card debt. And on the effects of indebtedness generally, see, for example, Melissa B. Jacoby, *Does Indebtedness Influence Health? A Preliminary Inquiry*, 30 J.L. MED. & ETHICS 560, 561 (2002), which surveys studies that suggest a causal link between indebtedness and health problems and concludes that "[i]ndebtedness may trigger stress that worsens health, or indebtedness may limit an individual's ability to seek preventative medical care and make health-maximizing choices generally."

⁴ This does not mean that the minimum standard should be set by regulation. For example, in some cases regulation that mandates disclosure of product attributes, and/or a standardized, government or nongovernment, ranking of product safety will induce sellers to offer safe products.

⁵ See Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. CHI. L. REV. 111, 128-32 (2006) (arguing that the consumer credit card market functions well and that anything more than light-handed regulation would raise consumers' transaction costs or create anticompetitive harm); Richard A. Epstein, *The Neoclassical Economics of Consumer Contracts*, 92 MINN. L. REV. 803 (2008) (asserting that regulation reduces overall output in the regulated sector and causes spillover economic losses outside of the regulated sector).

regulation and suggests how such regulation can support optimal market functioning.

Two clarifications are in order: First, we are not claiming that the current regulation of physical products is perfect, or that regulation of credit products is completely absent. Our claim is that regulation of physical products is more broadly accepted and more effective than the regulation of credit products. Second, we are not claiming that all potentially dangerous physical or credit products should be regulated. Regulatory intervention is necessary only when markets are shown to fail, as elaborated below.

Today, consumers can enter the market to buy physical products, confident that they will not be deceived into buying exploding toasters and other unreasonably dangerous products. They can concentrate their shopping efforts in other directions, helping drive a competitive market that keeps costs low and encourages innovation in convenience, durability, functionality, and style. Consumers entering the market to buy financial products should enjoy the same benefits.

I. THE PROBLEM

A. *The Theory: Why Markets for Consumer Credit Products Are Failing*

Credit products are a species of contract. Conceptually, an agreement to lend money is no different from any other contract. In the ideal prototype, each party agrees to a certain set of terms, creating a wealth-enhancing transfer for both sides. The role of law is thus limited—to enforce the parties’ contract, not to meddle with it.

The freedom-of-contract principle and faith in the value of free markets are premised on a number of assumptions, specifically that the contracting parties are informed and rational. In the area of consumer credit products, not only are these assumptions untested, but in many cases both theory and evidence suggest they are unrealistic or directly contradicted by the available data.⁶ When those assumptions are not reliable, then freedom of contract shifts from a system to enhance consumer welfare, and social welfare more generally, to a tool used by more sophisticated parties to take consumers’ money without giving value in return.

⁶ Consumers who are imperfectly informed and imperfectly rational make mistakes. John Campbell has argued that mistakes are “central to the field of household finance.” John Y. Campbell, President, Am. Fin. Ass’n, Household Finance (Jan. 7, 2006), in 61 J. FIN. 1553, 1554.

We focus on the risk associated with using products. Of course, all products carry risks. A toaster, if not used carefully, can cause serious physical harm. Similarly, a credit card, if not used carefully, can cause serious financial harm. Yet toasters and credit cards are ever present despite the risks that they pose. These products are ubiquitous because they provide substantial benefits alongside the serious risks. If an informed consumer purchases a toaster after accurately concluding that the benefits of the product outweigh the risks, then the transaction is welfare enhancing.⁷ Moreover, informed rational consumers will minimize product risk by taking optimal care. And a market populated by informed rational consumers will force manufacturers and issuers to offer a reasonable level of product risk by optimally designing their products.⁸

The problem, of course, is that consumers are not always perfectly informed, and very few consumers are perfectly rational. When the ideals of perfect information and perfect rationality are replaced by their real-world counterparts, imperfect information and imperfect rationality, the rosy picture of optimally designed products and welfare-maximizing transactions must be redrawn.

Markets and contracts can be relied upon to maximize welfare only when consumers are rational and informed. If consumers do not know what they are buying, markets might not give them what they would have bought had they known. If consumers have no information about the risks associated with a specific toaster or do not understand these risks, then manufacturers will not invest in designing and producing low-risk toasters. Why would a manufacturer spend money on improving its product if uninformed consumers will not reward the manufacturer with a higher price—which, in a competitive market, is necessary to cover the higher costs of the better, safer product?⁹

The same is true for consumer credit products. It may not be very expensive to design and offer a high-quality, welfare-maximizing credit card contract. But the *alternative* costs of such an optimal contract to the issuer might be substantial. For example, if consumers

⁷ We abstract at this stage from the possibility of negative externalities. For a discussion of the negative externalities generated by credit products, see *infra* Part I.C.2.

⁸ STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* ch. 3 (1987).

⁹ See *id.* (analyzing cases where consumers know only average risks). It should be emphasized that the social objective, against which the ramifications of imperfect information are measured, is not the production of zero-risk products. It will generally be socially optimal to bear a positive risk level. The point is that imperfect information will lead to excessive risk.

know only the standard interest rate and annual fee associated with a specific card, issuers would offer cards with high penalty interest rates and fees. Foregoing these high penalties would impose a substantial cost on the issuer. If the improved contract would not attract more business and would not allow the issuer to charge higher nonpenalty interest rates and fees, then there would be no reason for an issuer to offer a better contract with more reasonable penalties. Moreover, an issuer who offers an efficient contract with lower penalties and higher nonpenalty prices will lose business to a competitor who offers an inefficient contract with higher penalties and lower nonpenalty prices.

Imperfect rationality exacerbates these problems. An uninformed yet rational consumer would understand that she is buying a dangerous product because she understands that sellers have no incentive to invest in making a safer product given consumers' imperfect information.¹⁰ But the rational uninformed consumer would at least reach the correct decision about whether to purchase the dangerous product. And if she decides to purchase the dangerous product, the rational consumer will exercise the appropriate level of care. Not so for the imperfectly rational consumer. The optimistic consumer who underestimates the risks associated with the product might purchase a product when the benefits do not outweigh the risks. Instead, the underestimating consumer would consider purchasing the product whenever the benefits outweighed the *perceived* risks.¹¹ Moreover, this imperfectly rational consumer will not take adequate care when using the product, thus risking substantial injury.

The application of these principles in the credit card market, for example, illustrates the welfare costs. An imperfectly rational consumer might underestimate the likelihood of a penalty-triggering event. This consumer, even if she is aware of the high penalties, will underestimate the risk associated with high penalties. Consequently, this consumer might obtain a credit card that is not welfare maximizing for her. Moreover, she might use this credit card in a way that unduly exposes her to the risk that penalties will be imposed.

All markets suffer from the risk that consumers will be underinformed and therefore make judgments that are not welfare enhancing. In the market for ordinary consumer products, safety risks—

¹⁰ The rational uninformed consumer would understand that the market equilibrium features a dangerous product. Still, if consumers cannot identify the safe seller, no sellers would have a reason to try to change this equilibrium. *See id.* at 52-53.

¹¹ *Id.*

exploding toasters, lawnmowers that slice off toes, baby toys covered with lead paint, infant seats that crumple on impact, and so on—are regulated. Effects that are difficult for consumers to see and evaluate in advance of purchase are tested and controlled. Consumers are then free to inform themselves about other, more visible features. Sellers also benefit because they are protected from competition from high-risk alternatives.¹²

Consumer credit products are not inherently safer than physical products. Nor are markets for credit products inherently superior to markets for physical products in curbing the imperfect information and imperfect rationality that might allow safety risks to persist. In fact, as we discuss below, certain features unique to consumer credit products render markets for these products especially vulnerable to the problems of imperfect information and imperfect rationality. As we develop later in the Article, at least three features of credit products make them particularly dangerous for consumers to use: (1) the complexity of credit products,¹³ (2) lenders' ability to change the terms of credit products at low cost, simply by printing and mailing a new form, and (3) lenders' ability to apply changes to existing customers by sending contract amendments after a customer uses the product. For now, we note that creditors often design dangerous contracts as a strategic response to consumers' underestimation of the risks that these contracts-products entail.

In the remainder of this Part we explore why credit product markets fail. We begin with a description of three forces—learning by consumers, information provided by third parties (e.g., *Consumer Reports*), and information provided by sellers—that work in many markets to reduce imperfect information and imperfect rationality.¹⁴ We argue that these forces, while undeniably important, have only limited

¹² See Adler, *supra* note 2, at 82-83 (describing the creation of the Consumer Product Safety Commission to regulate safety of consumer goods).

¹³ Many physical products are also complex—for example, electronic gadgets. Yet with physical products the benefits are often more complex than the costs. The product may have multiple and complex value-increasing features but a simple, one-dimensional price. An exception is complex physical products where different components have different probabilities of failure and different costs associated with these failures. Sellers have a strong incentive to educate consumers about complex benefits; they have a much weaker incentive to educate consumers about complex costs. It should also be emphasized that complexity is, to some extent, endogenous. If consumers fail to comprehend the cost of a complex product, sellers will have an incentive to produce an inefficiently high level of complexity.

¹⁴ A fourth force is reputation. Reputation can be viewed as a learning mechanism, and, therefore, we do not treat it separately.

power to expose credit risks and to influence the development of safer products in the credit marketplace. We then examine the informed-minority argument—the claim that a small number of informed, rational consumers are enough for markets to work well. According to this argument, even if many imperfectly informed and imperfectly rational consumers remain, the informed minority will drive the market to behave as if all consumers were perfectly informed and perfectly rational and to offer only reasonably safe products. We explore why detailed recordkeeping about customers and the ability of credit issuers to customize their products undercut the impact of the informed-minority principle in consumer credit markets.

Finally, we focus attention on an underappreciated category of missing information that increases the risk associated with credit products: use-pattern information, meaning information about how the consumer will actually use the product. Use-pattern information often receives less attention than product-attribute information because consumers are assumed to know how they are going to use the product, or, at least, they are assumed to anticipate their future use more accurately than sellers. These assumptions, while valid in many markets, are invalid in important consumer credit markets. In these markets, counterintuitively, sellers often know more than consumers about consumers' use patterns. Use-pattern information creates opportunities for creditors to tailor their products to match individuals' cognitive errors, thus magnifying consumer risks. Moreover, consumers' use-pattern mistakes can be less susceptible to the three mistake-correction forces described above.

We discuss below each of these theoretical problems that undermine efficiency in the credit products market. We then turn to the data showing how consumers are making consistent, costly errors in dealing with dangerous consumer credit products. We conclude this Part with a discussion of the impact of these market failures on the harm to consumers and on the externalities imposed on third parties.

1. The Limits of Learning

Imperfect information leads to more dangerous products. Manufacturers of lawnmowers will produce lawnmowers with a higher probability of causing harm or lawnmowers that cause greater harm in the event of an accident. Similarly, lenders will offer contracts that inflict higher financial harm on consumers who suffer a penalty-triggering

financial accident. Moreover, these contracts might even increase the probability of such a financial accident.¹⁵

Why do consumers remain uninformed? If information can eliminate dangerous products, why don't consumers simply invest in information acquisition? Imperfect rationality provides one answer. Consumers do not seek to acquire more information because they are not aware that they need more information or that more information is available for them to acquire. Put differently, an imperfectly rational consumer might not be aware of the fact that she is uninformed.¹⁶ Alternatively, an imperfectly rational consumer might be aware that she is uninformed, yet mistakenly believe that the unknown information is trivial, irrelevant, or insufficiently important to justify the cost of its acquisition. For example, a consumer who mistakenly believes she will never make a late payment on her credit card will not even try to learn the penalty fees and interest rates for late payments.¹⁷ Or a consumer might know she is imperfectly informed, but she might conclude that the information she needs is not available or not available at a reasonable cost. For example, given the complexity of the average credit card contract and the legalistic language used in this contract, even a consumer who would be willing to invest time and effort to learn the terms of the contract might assume that they are too obscure for her to master. And those consumers who actually invest the time and effort to read the contract might not understand it, or, even if they understand the terms themselves, these consumers might underestimate the risks implied by these terms.¹⁸

¹⁵ See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1377 (2004) (stating that credit card companies frequently incentivize excessive purchases with "[z]ero annual and per-transaction fees, [and] benefits programs").

¹⁶ See generally Eddie Dekel, Barton L. Lipman & Aldo Rustichini, *Standard State-Space Models Preclude Unawareness*, 66 ECONOMETRICA 159 (1998) (examining "the extent to which commonly used models [of bounded rationality] need to be modified in order to capture unawareness").

¹⁷ A similar problem arises if the consumer underestimates the likelihood of being late rather than dismissing the possibility of being late altogether. The benefit of learning the late fees and rates is proportional to the likelihood of being late. And the perceived benefit of learning the late fees and rates is proportional to the perceived likelihood of being late. The smaller the perceived benefit of becoming informed, the smaller the likelihood that this perceived benefit will exceed the cost of becoming informed, and the smaller the likelihood that the consumer will become informed.

¹⁸ See U.S. GOV'T ACCOUNTABILITY OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS 46-51 (2006) [hereinafter GAO, INCREASED COMPLEXITY REPORT] (presenting the results of interviews with credit card holders and examining the reasons for the confusion exhibited by the cardholders with respect to credit card terms); see also U.S.

But there is an even simpler answer, one that does not rely on imperfect rationality. Consumers are uninformed because information is costly to acquire.¹⁹ This is especially true with respect to modern consumer credit products. The standard credit card or mortgage contract has gotten longer and more difficult to read, and comparison among such contracts is challenging even for a professional. Moreover, lenders retain the right to change the contract at will, so that even a consumer who understands the initial contract may be required to invest more and more time to continue to stay abreast of multiple changes added to the contract and to compare those changes with other available credit products.²⁰

GOV'T ACCOUNTABILITY OFFICE, CREDIT CARDS: CUSTOMIZED MINIMUM PAYMENT DISCLOSURES WOULD PROVIDE MORE INFORMATION TO CONSUMERS, BUT IMPACT COULD VARY 26-28 (2006) [hereinafter GAO, CUSTOMIZED DISCLOSURES REPORT] (assessing the feasibility and usefulness of providing cardholders with customized information about the financial consequences of making minimum payments). Failure to comprehend the implications of available information is the product of imperfect rationality and cognitive bias. Evidence suggests that learning to overcome such biases is imperfect, especially in the context of financial decisions. See Thomas Gilovich & Dale Griffin, *Introduction to HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT* 1, 5-7 (Thomas Gilovich et al. eds., 2002) (suggesting through experimental evidence that, while learning is generally effective in minimizing mistakes, biases in relatively abstract domains like math and finance are more resilient); Michael Haigh & John List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. FIN. 523, 529 (2005) (documenting persistent bias, specifically myopic loss aversion, even among financial professionals who have ample opportunity to learn); Keith Stanovich, *The Fundamental Computational Biases of Human Cognition: Heuristics that (Sometimes) Impair Decision Making and Problem Solving*, in THE PSYCHOLOGY OF PROBLEM SOLVING 291 (J.E. Davidson & R.J. Sternberg eds., 2003) (same); Sumit Agarwal et al., *The Age of Reason: Financial Decisions over the Lifecycle* (MIT Dep't of Econ., Working Paper No. 07-11, Feb. 11, 2008), available at <http://ssrn.com/abstract=973790> [hereinafter Agarwal et al., *Age of Reason*] (same); Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?* 4, 11 (Nov. 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=843826> [hereinafter Agarwal et al., *Credit Contracts*] (reporting that, even given a relatively simple choice between two credit card contracts, consumers often make suboptimal decisions).

¹⁹ For example, Kornhauser states that “[d]issemination and acquisition of information, which play important roles in the setting of prices, involve costs. Imperfections arise from rational agents economizing on these costs.” Kornhauser, *supra* note 1, at 1156. Of course, this costliness applies to information that affects quality as well as price.

²⁰ See GAO, CUSTOMIZED DISCLOSURES REPORT, *supra* note 18, at 14-15 (evaluating the possibility of providing consumers with standardized and customized “minimum payment estimates”); GAO, INCREASED COMPLEXITY REPORT, *supra* note 18, at 33, 36-48 (identifying reasons for consumers’ failure to understand credit card disclosures). And again imperfect rationality exacerbates the problem. An imperfectly rational consumer might underestimate the likelihood and impact of a midstream change in the contract, and thus fail to acquire information about such changes.

The cost of becoming informed might not be prohibitive if it were distributed across all consumers. Many consumers buy the very same lawnmower. Similarly, credit card and mortgage contracts are standard form contracts, offered virtually unchanged to many consumers. If each and every consumer must invest independently in learning about the product, the cost of acquiring the necessary information might exceed the benefit of the information to the individual consumer. If, however, the information could be learned once and be disseminated to all consumers, the aggregate benefit would surely exceed the cost.

The public-good nature of information might generate a collective-action problem that prevents consumers from becoming informed. Individual consumers may reason as follows: If all other consumers are informed, then dangerous products will not be offered, and I have no reason to invest in acquiring information about the dangerousness of the product. Conversely, if all other consumers are not informed, then only dangerous products will be offered. A single informed consumer will not affect market dynamics. Thus, there is no reason to invest in acquiring information about the dangerousness of the product.²¹ The conclusion is abrupt: individual consumers have insufficient incentives to invest in acquiring information.

This does not mean that learning is entirely absent. Some errors can be quite instructive. A consumer who is initially unaware of a currency-conversion fee on her credit card will learn about this fee after returning from a vacation abroad and receiving the credit card bill. Other errors are much less informative, as the data on fee/interest choices show. Our point is not that learning never occurs; rather it is that the learning is imperfect and that the remaining errors impose substantial welfare costs.

2. Why Getting Smarter Collectively Does Not Work

In the case of physical products, the collective action problem is partially solved by publications such as *Consumer Reports*. *Consumer Reports* invests in information acquisition and sells that information to

²¹ To be sure, knowledge about dangerousness is useful in deciding whether to buy the product, even if this knowledge will have no effect on the quality of the product. But consumers already know that the product is dangerous. The fact that consumers are uninformed means that they cannot identify and reward with a higher price a seller/lender who offers a safe product. A rational consumer, even if uninformed, realizes that the market equilibrium will feature dangerous products.

individual consumers. *Consumer Reports* buys competing products, runs tests, and publishes reports. It compiles this information in ways that facilitate comparison shopping, thus supporting the efficient operation of the market.

Consumer Reports saves consumers the cost of collecting and compiling information, but it cannot completely eliminate the cost of becoming informed. Each consumer must still subscribe to and read the report in *Consumer Reports*, and she must remember it when shopping. As *Consumer Reports* covers more products and as the report on each covered product becomes more detailed and informative, the cost of reading the report increases for each consumer. Even in the age of the Internet and when digital search further reduces the cost of reading, a relatively small proportion of consumers regularly consult *Consumer Reports* or its equivalents.²² Because the cost of becoming informed is not completely eliminated, the collective action problem persists.²³ Similarly, consumers' imperfect rationality imposes limits on the effectiveness of the protection *Consumer Reports* can offer.²⁴

The nature of financial products further limits the effectiveness of *Consumer Reports*, or any similar organization, to inform consumers and correct market imperfections. Because of the complexity and multiplicity of the products, *Consumer Reports* must invest substantial resources in collecting and compiling the necessary information about credit products. By comparison with physical products like the lawnmower, credit products often come in many more shapes and sizes. Compare, for example, the number of lawnmowers *Consumer*

²² "Consumer Reports magazine . . . has about 4 million subscribers." ConsumerReports.org—Our Mission, <http://www.consumerreports.org/cro/aboutus/mission/overview/index.htm> (last visited Oct. 1, 2008).

²³ Each consumer reasons that if all other consumers read *Consumer Reports* she does not need to read it herself, because only safe products will be offered on the market. And if all other consumers do not read *Consumer Reports*, only dangerous products will be offered regardless of whether she reads *Consumer Reports* or not. Since all consumers reason in a similar fashion, the incentive to read *Consumer Reports* is inadequately low.

²⁴ An imperfectly rational consumer might find it difficult to process the information provided by *Consumer Reports* and to use this information when deciding which product to buy. Specifically, evidence suggests that the average consumer considers only a handful of attributes when deciding which product to buy. Even if a consumer reads the detailed report provided by *Consumer Reports*, she is likely to internalize only a small portion of the information summarized in the report. In addition, as noted above, optimism can lead consumers to underestimate product risks, or to underestimate their own exposure to product risks. Such optimism would reduce a consumer's incentive to read *Consumer Reports*.

Reports evaluated in its most recent report on yard equipment (36)²⁵ with the number of different credit cards offered by a single issuer (Bank of America, for instance, offers over 400 different cards on its website).²⁶ Multiply the number of cards by the ten largest issuers and add in the cards offered by the next two hundred issuers and the scope of the rating task becomes clearer. This is not to say that there are no complex physical products: automobiles, personal computers, and other electronic gadgets suffer from similar complexity and multiplicity problems. But consumer credit products are surely among the more complex, multidimensional products in the marketplace.

Second, as compared to physical products, credit products can more easily be changed, further increasing the cost of information collection. To change a lawnmower, the manufacturer needs to redesign an assembly line. To change a credit card product, the issuer need only print out a new piece of paper. Moreover, a lawnmower cannot be changed after it has been delivered to the consumer. A credit card, on the other hand, can be readily changed, even when it is already in the consumer's wallet, simply by sending out a mailing that alters the terms of the agreement. The ease of product change would require constant vigilance on the part of *Consumer Reports*—and on the part of the consumers who relied on *Consumer Reports*' help.

Finally, credit card issuers are not required to treat all customers alike, further complicating the benefits of collective evaluation. For example, three people might hold the same card on June 1, but by July 1, one might continue to hold the same card, one might hold a card with a few more onerous terms, and one might hold a card with substantially more onerous terms. The identifying logos on the card and the name of the affinity program might remain the same, even as the terms applicable to each customer differ dramatically. In such a case, evaluation of the initial contracts by *Consumer Reports* would not only be inadequate, it would be affirmatively misleading. Continuous evaluation on a consumer-by-consumer basis of the different changes that each card undergoes would entail prohibitive costs.²⁷

²⁵ *Lawn Mowers: More Make the Cut*, CONSUMER REP., May 2006, at 38.

²⁶ Bank of America, Credit Cards Overview, <http://www.bankofamerica.com/creditcards/> (last visited Oct. 1, 2008).

²⁷ In theory, the problem of midstream changes can be curbed if *Consumer Reports* rates issuers according to the number and reasonableness of their mid-stream changes. In practice, however, such rating would entail substantial cost, since *Consumer Reports* would have to survey credit card customers with annoying frequency and rely on both their understanding of the changes that had been imposed and their willingness to

The purchase of a lawnmower and the decision to use a credit card face yet another difference: if the customer decides the lawnmower has become unsafe, she can stop using it. The grass may grow, but she does not have to take on newly appreciated risks. For a customer who has made purchases on the credit card with the plan of paying over the next two years, however, such an option may not exist. She may stop using the card for new purchases, but the outstanding debt balance will subject her to the new terms even if she sees them as now unacceptably risky. The only credit card users who will have the option to avoid risky changes in the terms of their cards will be those who carry no credit balances or who have adequate savings or other credit options so that they can pay off any balance in full. The majority of credit card users carry a balance,²⁸ and many, especially lower-income consumers, cannot pay off their credit card balances in response to a midstream change of terms.

Consumer Reports may help level the information playing field with many manufactured products, but the nature of credit products limits its effectiveness in this sphere. Given the complexity, fluidity, and diversity of credit products, *Consumer Reports* is largely confined to general education articles (“Watch Out for These Ten Scams”).²⁹ This is, of course, a useful undertaking, but it hardly corrects widespread market imperfections.

3. Why Sellers Do Not Educate Consumers

Mistake-correction efforts by sellers can sometimes minimize imperfect information and imperfect rationality in consumer markets. Consider the following, arguably common, scenario: Seller *A* offers a product that is better and costs more to produce than the product offered by seller *B*. Consumers, however, underestimate the added value from seller *A*’s product and thus refuse to pay the higher price that seller *A* charges. In this scenario, seller *A* has a powerful incen-

reveal such changes. The large number of different credit card contracts further increases the cost of maintaining such a rating. The considered rating system would become feasible if issuers—forced by regulation or motivated by reputational concerns—publicly disclosed all midstream changes.

²⁸ See Brian K. Bucks, Arthur B. Kennickell & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL., Mar. 22, 2006, at A1, A30 (“From 2001 to 2004, the proportion of families carrying a balance rose 1.8 percentage points, to 46.2 percent.”).

²⁹ See *Credit Cards: They Really Are Out to Get You*, CONSUMER REP., Nov. 2005, at 12 (detailing how credit cards have “become much more treacherous for consumers”).

tive to educate consumers about her product—to correct their underestimation of the product's value.

But if both seller *A* and seller *B* and many other sellers offer identical products or offer different products that share a certain product risk, the incentives change. If seller *A* reduces this risk and invests in educating consumers about the benefits of her superior product, then seller *A* will attract a lot of business and make a supracompetitive profit. But this is not an equilibrium. After seller *A* invests in consumer education, all the other sellers will free-ride on seller *A*'s efforts. They will similarly reduce the product risk and compete away the profit that seller *A* would have made. Anticipating such a response, seller *A* will realize that she will not be able to recoup her investment. Seller *A* will thus be less likely to improve the safety of her product, and instead will continue to offer a higher-risk product. This collective-action problem can lead to the persistence of consumer misperception.³⁰ For example, if Citibank wanted to issue credit cards without a universal-default clause, it would have to invest resources in correcting consumers' underestimation of how much universal default costs them. If Citibank was successful in convincing consumers that they should look for cards without universal default, then other issuers will also offer such cards, quickly competing away any potential return on Citibank's consumer-education investment.

To be sure, sellers of physical products face the risk that, if they invest in educating the public about the benefits of innovations they offer, their competitors will imitate these innovations and capture a portion of the benefits of that education at little or no cost. But once

³⁰ See Howard Beales et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 527 (1981) (explaining why sellers might not disclose both positive and negative information); see also Campbell, *supra* note 6, at 1586-88 (describing the limits of competition, specifically the collective-action problem that prevents sellers from educating consumers, in the mortgage market); R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 659 (1996) (explaining that free riding disincentivizes information sharing); Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168, 173 (2002) (applying the general argument in Beales et al., *supra*, in the consumer credit context). In some markets the first-mover advantage will be large enough to overcome the collective-action problem. For a general discussion of information failures in consumer markets, see Beales et al., *supra*, at 503-509. On the limits of advertising as a mistake-correction mechanism, see also Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505, 512-21 (2006); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1242-43 (2003).

again, the ease with which credit contracts can be altered exacerbates this problem. While the manufacturer of a physical product might count on the fact that it would take months or even years for a competitor to redesign a product to include the innovation, another credit issuer could adopt a new practice in a matter of weeks.³¹ Moreover, innovators of physical products have the chance to protect their innovations through patents, while no such options are available to those whose products are credit.³²

Finally, sellers of physical products can often point to a specific, easy-to-understand feature that improves safety—for example, an automatic braking system, a child-proof lid, etc. Because many features of financial products are exceedingly complex, it would be difficult both to inform future customers about the feature and to alert them to its presence elsewhere. If, for example, Citibank dropped double-cycle billing, it would face a very difficult time explaining to consumers what the change meant and, because billing practices are often not even listed in the printed credit card contract, an even tougher time encouraging consumers to avoid products that involve double-cycle billing.

Sellers of financial products sometimes provide information to consumers and even help consumers process this information. For example, the websites of credit card issuers provide assistance in choosing among the many different cards offered through the website. The consumer need only enter her credit rating, preferences, and anticipated use-patterns and the website will recommend the appropriate card.³³ These card-selection algorithms are helpful, but they

³¹ And the credit issuer would be able to apply the new practice to both existing and new customers, while the manufacturer of a physical product would typically apply the new design only to new customers.

³² Even apart from this collective action problem, sellers might prefer not to correct consumer mistakes and might even invest in creating misperception. Arguably, manipulation of consumer perceptions, and even preferences, is a main purpose of advertising. See Edward L. Glaeser, *Psychology and the Market*, 94 AM. ECON. REV. 408, 409-411 (2004) (“Markets do not eliminate (and often exacerbate) irrationality The advertising industry is the most important economic example of these systematic attempts to mislead, where suppliers attempt to convince buyers that their products will yield remarkable benefits It is certainly not true that competition ensures that false beliefs will be dissipated. Indeed in many cases competition will work to increase the supply of these falsehoods.”). In a later piece, however, Glaeser argues that government decision makers have weaker incentives than consumers to overcome errors, and thus intervention in markets might make things worse. Edward L. Glaeser, *P paternalism and Psychology*, 73 U. CHI. L. REV. 133, 144 (2006).

³³ See, e.g., Capital One Credit Cards: Find the Card for You or Build Your Own Credit Card, <http://www.capitalone.com/creditcards/>; Citi Credit Cards, Find the Per-

are not designed to eliminate consumer errors. First, consumers might not have accurate information, for example, on their future use patterns, to enter into the card-selection algorithm. Second, it is not clear that the algorithm will recommend the card that is best for the consumer, rather than the card that is best for the issuer. Third, certain undesirable product features, for example, double-cycle billing, may be common to all of the many cards offered by the issuer. In such cases, the card-selection algorithm will not steer the consumer toward a better product. More generally, when a product dimension, for example, interest rates or rewards programs, becomes salient to consumers, competition will focus on this dimension. Sellers will inform consumers about how attractive their products are on the salient dimension, and card-selection algorithms will emphasize the salient dimension. The problem is that not all dimensions are salient to consumers. And for the nonsalient dimensions, such as double-cycle billing, sellers have much weaker incentives to inform consumers.³⁴

Indeed, there is some evidence that creditors are not able to inform consumers about safer products. The example of Citibank is instructive. In the wake of complaints by consumer groups, investigations by Congress, and significant press coverage, Citi announced that it would stop two of the most dangerous consumer practices associated with credit cards: universal default and any-time interest rate changes. The company made a large public show of the decision, receiving substantial praise in Congress and elsewhere. Within two years, Citi announced that it was reinstituting universal default. John P. Carey, the chief administrative officer for Citigroup's credit card unit explained, "[w]e hoped and expected that these two points of differentiation would lead customers to vote with their feet. . . . We have been disappointed with the results we have seen so far."³⁵ When the largest credit card issuer in the country has given the most public launch of a safety feature and it is nonetheless unable to explain to consumers why they should choose this safer card, the limits of creditor education become clear.

fect Credit Card, <https://www.citicards.com> (offering selection boxes for "general consumer," "small business owner," and "college student," as well as various features, such as rewards and interest rate promotions).

³⁴ Salience is, to some extent, endogenous. Sellers could make a nonsalient attribute salient. But often there will be little incentive for them to do so. See Gabaix & Laibson, *supra* note 30, at 517-20.

³⁵ Eric Dash, *Citigroup Considers Repealing a Pledge, and the Slogan with It*, N.Y. TIMES, June 25, 2008, at C4 (quoting John P. Carey, Chief Admin. Officer, Citibank Credit Card Unit).

4. Why the Informed Minority Does Not Drive the Market

Many consumers are uninformed and irrational. This is true for both credit products and physical products.³⁶ Still, most markets work reasonably well. Why? The answer is that, in most markets, relatively few informed, rational consumers can wield enough influence to ensure the efficient operation of the market. Under certain reasonable conditions sellers will offer safe products to attract those few informed consumers, and the uninformed majority will benefit.³⁷

The informed minority wields less power in the market for consumer credit products for two reasons. First, it is not clear that informed consumers will constitute a sufficiently large number to drive the market. A recent survey study conducted by the Auriemma Consulting Group found that “only a third of consumers applying for a

³⁶ See, e.g., *Ting v. AT&T*, 182 F. Supp. 2d 902, 912 (N.D. Cal. 2002) (noting that many AT&T customers who received a new service contract with their monthly bill failed to skim or even look at the new contract, even when it was labeled as important information), *aff'd in part, rev'd in part*, 319 F.3d 1126 (9th Cir. 2003); *Allan v. Snow Summit, Inc.*, 59 Cal. Rptr. 2d 813, 824 (Cal. Ct. App. 1996) (refusing relief to a party to an adhesion contract where the provision in question was clear but the party failed to read it); *Davis v. M.L.G. Corp.*, 712 P.2d 985, 993 (Colo. 1986) (recounting the testimony of an automobile rental agent that she “had never observed any of her customers reading the reverse side of the [rental] agreement,” which contained provisions limiting the company’s liability); *Unico v. Owen*, 232 A.2d 405, 410 (N.J. 1967) (“The ordinary consumer goods purchaser more often than not does not read the fine print”); *Holiday of Plainview, Ltd. v. Bernstein*, 350 N.Y.S.2d 510, 512 (N.Y. Dist. Ct. 1973) (“[I]t is true that defendant (as have many before him and probably many will after him) failed to read the entire contract”); *Elliot Leases Cars, Inc. v. Quigley*, 373 A.2d 810, 813 (R.I. 1977) (“It is common knowledge, and so should have been known to [the car leasing company], that the detailed provisions of insurance contracts are seldom read by consumers.”); *Val Preda Leasing, Inc. v. Rodriguez*, 540 A.2d 648, 652 (Vt. 1987) (finding that an average consumer would not understand the numerous exceptions to the limitation on liability for damage to the rental car); RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b (1979) (“A party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms. . . . Customers do not in fact ordinarily understand or even read the standard terms.”).

³⁷ See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1450 (1983) [hereinafter Schwartz & Wilde, *Imperfect Information*] (“[F]irms probably cannot distinguish the consumers who read from those who did not,” so “if enough shoppers exist . . . [.] that the nonshoppers do not read is irrelevant; they benefit from the shoppers’ efforts.”); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 637-38 (1979); Alan Schwartz & Louis L. Wilde, *Product Quality and Imperfect Information*, 52 REV. ECON. STUD. 251, 251-52 (1985).

new credit card do so after researching the cards available to them.”³⁸ The study also found that “[n]early half of applicants apply for a new credit card spontaneously, with no prior thought given to obtaining an additional card.”³⁹ With a large, uninformed customer base, the market may feel little disciplinary effect from informed consumers.

Second, the informed-minority argument relies on sellers’ inability to discriminate between the informed minority and the uninformed majority. But if a seller can offer two products—a better product to informed consumers and a shoddier one to uninformed consumers—then the benefits that uninformed consumers would enjoy when a critical mass of informed consumers exist in a market disappear. In the consumer credit market, sellers have substantial information about each and every consumer and the capacity to tailor products to each customer. Accordingly, the no-discrimination assumption is unrealistic. In these markets, informed consumers may get safer products, but there is no reason for that benefit to carry over to the uninformed consumers.

An example of the latter form of discrimination surfaced during Congressional hearings years ago. Then-Representative (now-Senator) Bernie Sanders of Vermont told the story of a credit card issuer that raised every customer’s interest rate by 2%. The rate increase was not tied to changes in the cost of funds or any difference in the customers’ ability to repay. Instead, the increase was across the board. When a handful of customers called to complain, the company immediately apologized and rescinded the increase.⁴⁰ For everyone else—those who were not sophisticated enough to call—the increase stuck.⁴¹

³⁸ *Card Applications*, May 16, 2007, <http://www.cardweb.com/cardflash/2007/05/16/card-applications>.

³⁹ *Id.*

⁴⁰ A similar phenomenon concerns the selective waiving of fees, specifically late and overlimit fees, for customers who call to complain while leaving such fees in place for those who do not know this will work.

⁴¹ Warranties are another common solution to the problem of uninformed consumers. In markets from automobiles to electrical appliances and computers, seller warranties protect customers against safety defects. But in the financial-products market, such warranties make less sense. Several difficulties—from defining the financial benchmark for measuring harm, through proving causation, to diluting consumers’ incentives—explain why financial products do not come with warranties. These difficulties may also explain why credit-products liability is not recognized. John Pottow has recently argued that reckless lending should give rise to a cause of action in tort or, at least, should preclude reckless lenders from recovering in bankruptcy. Pottow, *supra* note 1, at 420-21. Pottow discusses the shortcomings of a warranty or liability solution,

5. Who Knows the Most About Me?

The relative dangerousness of credit products turns on another aspect of imperfect information: how an individual consumer will use the product. If a customer misestimates her own use patterns, such as the likelihood that she will go over her credit limit or be unable to make a payment because of an income shock, then she will select the wrong card and use it in the wrong way. Consumers can always make errors about how they might use any product, but the complexity of credit products and the number of exogenous factors, such as jobs, medical problems, and family breakups, make them particularly subject to this form of misestimation.⁴² Moreover, while use patterns are, of course, relevant to both physical products and credit products, payments from buyer to seller are usually independent of use patterns for physical products and very much dependent on use patterns for credit products, and specifically for credit cards.

The impact of misestimation of the customer's own use is compounded in the credit market by the lender's superior ability to develop fairly accurate estimates of the consumer's future use. Sellers collect voluminous statistics about use patterns. Details of every transaction—the place, time, amount, merchant—are carefully recorded and preserved. The data are then combined with information about each customer—name, credit score, address, zip code, payment times, payment places, payment amounts, and so on. For issuers with multiple relationships with the debtor—home mortgage lender, credit card issuer, checking account bank, car lender, etc.—the opportunities to collect data multiply. These data can then be categorized by demographic or geographic groups, creating powerful prediction

but argues that these shortcomings are not critical. *Id.* at 441-51; *see also* Vern Countryman, *Improvident Credit Extension: A New Legal Concept Aborning?*, 27 ME. L. REV. 1, 17-18 (1975) (proposing that, “at a minimum, debtors should be allowed to assert the improvidence of a credit extension as a defense to repayment,” and, to a lesser extent, that the debtor and his other creditors should be entitled to recover from the improvident credit extender for any damages they can prove); Adam Goldstein, Note, *Why “It Pays” to “Leave Home Without It”: Examining the Legal Culpability of Credit Card Issuers Under Tort Principles of Products Liability*, 2006 U. ILL. L. REV. 827, 856-58 (proposing that credit card companies be exposed to product liability based upon their “defective” products).

⁴² For example, optimism about self-control and about the likelihood of adverse contingencies that could lead to borrowing will cause a consumer to underestimate future borrowing. The cost of borrowing—including interest rates, fees, and the risk of financial distress—would thus receive inadequate weight in the consumer's choice of a credit card. *See* Bar-Gill, *supra* note 15, at 1401.

models for others in similar groups. Or the data can be mined to create individual debtor profiles that expose particular consumer weaknesses. Based on past history and a few demographic characteristics, an issuer can generate an accurate estimate of the probability that a particular consumer will trigger a penalty—an estimate that is often more accurate than the consumer's own estimate of the same probability. As Duncan McDonald, former general counsel of Citigroup's Europe and North America card businesses, noted:

No other industry in the world knows consumers and their transaction behavior better than the bank card industry. It has turned the analysis of consumers into a science rivaling the studies of DNA

The mathematics of virtually everything consumers do is stored, updated, categorized, churned, scored, tested, valued, and compared from every possible angle in hundreds of the most powerful computers and by among the most creative minds anywhere. In the past 10 years alone, the transactions of 200 million Americans have been reviewed in trillions of different ways to minimize bank card risks.⁴³

Variations in use, and in lenders' possession of detailed use-pattern information, provide an opportunity for some lenders to customize their products to exploit consumer error to its fullest, far more than would be possible with physical products.

The importance of use-pattern information also affects the efficacy of the mistake-correction forces described above. With a standardized product (or feature), a consumer who discovers a certain hidden feature or unusual risk associated with the product can share this information with family and friends. Since the information pertains to a standardized product (or feature), its relevance to others is immediately clear. But interpersonal learning is less effective with respect to nonstandardized products or attributes. With a nonstandardized product, the information obtained by one consumer might not be relevant to another consumer who purchased a different version of the nonstandard good.

When the nature of the product is more broadly defined to include different potential use patterns, then the degree of standardization shrinks. Even an otherwise standardized product is nonstandardized with respect to use patterns, when different consumers use the product in different ways. This difference can inhibit learning of use-pattern information. After using a credit card for some time, a con-

⁴³ Duncan A. MacDonald, *Card Industry Questions Congress Needs to Ask*, AM. BANKER, Mar. 23, 2007, at 10.

sumer will obtain valuable use-pattern information, for example, on revolving patterns, on repayment patterns, and on the likelihood of late payment. But this information, while valuable to this specific consumer, is likely to be of little value to another consumer who will use the same card differently.

Third parties are also less effective in curing market imperfections whenever use-pattern variations are present. *Consumer Reports* can read several credit card contracts to evaluate their relative safety. *Consumer Reports* cannot interview each cardholder to learn about revolving balances, repayment rates, and late payments. *Consumer Reports* could interview a sample of cardholders and provide average use-pattern information, but the value of such information diminishes as heterogeneity among consumers rises. Similarly, expert advice⁴⁴—for example, how to evaluate credit cards or what kind of mortgage to buy—suffers from the same problem of matching the advice with a consumer’s particular pattern of use.⁴⁵

⁴⁴ Consumers, recognizing their imperfect rationality and the imperfection of the information at their disposal, take steps to limit the mistakes that they make. In particular, consumers seek advice and consult experts before entering the market. See, e.g., Richard A. Epstein, *Second-Order Rationality*, in BEHAVIORAL PUBLIC FINANCE 355, 361-62 (Edward J. McCaffery & Joel Slemrod eds., 2006). While clearly effective in many contexts, this indirect form of learning is also limited. Consumers do not seek advice before each and every purchase or use decision. When faced with a big decision, consumers are more likely to take the time and incur the cost of seeking expert advice. They are less likely to do so when faced with a smaller decision. For example, consumers are more likely to seek third-party assistance before taking on a substantial home equity loan. They are less likely to engage in substantial consultations before deciding to buy sneakers with their credit card. In many markets, consumers make many small decisions rather than a few large decisions. In these markets, reliance on expert advice is probably rare. To the extent that product-use decisions are smaller decisions, mistakes in product use are less likely to be cured by advice and consultation than mistakes in product purchasing. Use-pattern mistakes affecting product-choice decisions are also less likely to be cured by advice and consultation. Experts and other advice-providers can assist the consumer by providing product-attribute information and by offering more sophisticated analysis of this information. Third-party advisers, however, generally do not have superior information about the consumer’s wants and needs—an important determinant of anticipated product use. Evidence suggests that a substantial number of consumers do not seek advice before making financial decisions. See Victor Stango & Jonathan Zinman, *Fuzzy Math and Household Finance: Theory and Evidence* 59, tbl. 8 (Tuck Sch. of Bus., Working Paper No. 2008-41, Nov. 2007), available at <http://ssrn.com/abstract=1081633> (finding that approximately half of the households in the data sought advice, but over 30% of households with above-average bias levels did *not* seek advice; the bias that this study focuses on is underestimation of exponential growth, which leads to underestimation of the cost of short-term borrowing and of the return to long-term saving).

⁴⁵ The importance of use-pattern information also limits mistake correction by sellers and thus inhibits competition. Use-pattern information is available only to con-

B. *The Evidence: Markets for Consumer Credit Products Are Failing*

The preceding section argued that, in theory, credit product markets are likely to be affected by problems of imperfect information and imperfect rationality that can cause these markets to fail. In this section, we survey the empirical evidence and argue that imperfect information and imperfect rationality are serious problems in many credit product markets.⁴⁶

The evidence summarized below falls into three categories. The first includes survey evidence that attempts to assess directly the extent of consumer information by questioning consumers about credit. This methodology is obviously limited, but it nevertheless provides valuable insight. The second category of evidence, which we find more persuasive, indirectly assesses the limits on consumer information and rationality by measuring the behavioral effects of such limits. The central idea is that consumers make systematic mistakes in their choice of credit products and in their use of these products. These observed mistakes indicate the existence of deficits in either informa-

sumers themselves and to sellers. Many consumers do not collect, compile and retain the necessary information. Sellers do, but only after serving the specific consumer for a sufficiently long period of time. Because the main reason for sellers to educate consumers is to get their business, the result is a catch-22. The consumer's current provider has no incentive to educate the consumer, while the competitor, who has every incentive to educate the consumer, does not have the necessary information. The power of the informed-minority argument also diminishes as use-pattern information becomes more important. The informed-minority argument presumes that the missing information is equally relevant to all consumers—informed and uninformed. This assumption is necessary if the informed minority is to exert market pressure that will protect the uninformed majority. But individual use information can be relevant only to the individual consumer. An informed consumer who recognizes that he is prone to forgetfulness might avoid credit cards with high late fees. The theory of the informed minority posits that if enough consumers shun cards with high late fees, such terms will disappear from the market. But an informed consumer who possesses this use-pattern information, rather than switching cards, may choose to change use patterns. For example, that consumer may employ reminders or enter an automatic payment program to avoid paying a late fee. These steps will not help the uninformed consumer, who will continue paying late fees.

⁴⁶ Regulators are obviously concerned with consumer mistakes in credit product markets, as evidenced by their attempts to educate consumers. For example, the Federal Reserve Board (FRB) posts numerous Consumer Information Brochures on its website. Fed. Reserve Bd., Consumer Information Brochures, <http://www.federalreserve.gov/pubs/brochure.htm> (last visited Oct. 1, 2008); *see also*, Bd. of Governors of the Fed. Reserve Sys., Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You? 2-11 (Nov. 2006), http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf (discussing costs and benefits and comparing several similar mortgages with differing interest-rate structures).

tion or rationality—or both. Finally, perhaps the best evidence of consumers' lack of information or their systematic irrationality is in the credit products themselves, which are carefully designed to exploit any such problems. Accordingly, the observed product designs may prove the prevalence of information and rationality deficits.

1. Survey Evidence

Starting with the direct survey evidence: a recent study by the Center for American Progress and the Center for Responsible Lending found that 38% of consumers believe that “[m]ost financial products such as mortgage loans and credit cards are too complicated and lengthy for [them] to fully understand.”⁴⁷ Consumers who have dealt with credit products describe the language that forms the basis of their agreements with lenders as too complex to comprehend.

The experts confirm the consumers' intuition. A 2006 study by the United States Government Accountability Office (GAO) found that “many [credit card holders] failed to understand key terms or conditions that could affect their cost, including when they would be charged for late payments or what actions could cause issuers to raise rates.”⁴⁸ Moreover the GAO found that “the disclosures in the customer solicitation materials and cardmember agreements provided by four of the largest credit card issuers were too complicated for many consumers to understand.”⁴⁹

⁴⁷ CTR. FOR AM. PROGRESS ET AL., FREQUENCY QUESTIONNAIRE 8 question 47 (2006), http://www.americanprogress.org/kf/debt_survey_frequency_questionnaire.pdf (presenting the results of a survey of 1,000 adults, age eighteen and over, from the general population).

⁴⁸ GAO, INCREASED COMPLEXITY REPORT, *supra* note 18, at 6.

⁴⁹ *Id.* Edward Yingling, President and CEO of the American Bankers Association, admitted that the complexity of their products and contracts confuses consumers. See *Credit Card Practices: Current Consumer Regulatory Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs.*, 110th Cong. 14-15 (2007) (statement of Edward L. Yingling, President and CEO, Am. Bankers Ass'n) (acknowledging that the increased complexity of credit cards confuses consumers and can result in a difficult financial situation, but arguing that the industry is taking these concerns very seriously and working to address them). Comptroller of the Currency John Dugan similarly acknowledged that current credit card disclosure rules should be changed to improve consumers' ability to make well-informed decisions. See *Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 110th Cong. 14-16 (2007) (testimony of John Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency) [hereinafter *Consumer Protection Hearing*]. In response, the FRB and the Office of the Comptroller of the Currency (OCC) are revising the disclosure regulations under TILA. See Press Release, Fed. Reserve Bd.

These findings are reinforced by a 2007 study commissioned by the Federal Reserve Board (FRB). This study, based on focus group sessions and one-on-one interviews, found that many consumers poorly understand current credit card disclosures. The Federal Reserve identified terms that many consumers did not understand, including:

- many of the numerous interest rates listed;
- when issuers disclose a range of annual percentage rates (“APRs”), that their specific APR will be determined by their creditworthiness;
- that the APR on a “fixed rate” credit card product can change;
- what event might trigger a default APR;
- which balances the default APR will apply to;
- how long the default APR will apply;
- what fees are associated with the credit card product;
- how the balance is calculated (e.g., two-cycle billing);
- how payments are allocated among different rate balances;
- the meaning and terms of “grace period” and “effective APR”;
- the time, on the due date, that payment is due;
- when the introductory rate expires;
- how large the post-introductory rate is; and
- the cost of convenience checks.⁵⁰

The Federal Reserve Board is in the process of revising Regulation Z, which governs disclosure of terms and conditions of credit products. The Board proposes to redesign the disclosures required under Regulation Z and to adopt disclosure designs that the study revealed to be more effective.⁵¹ Yet even the more effective disclosure designs

(May 2, 2008), <http://www.federalreserve.gov/newsevents/press/bcreg/20080502a.htm>.

⁵⁰ MACRO INT’L, INC., DESIGN AND TESTING OF EFFECTIVE TRUTH IN LENDING DISCLOSURES, at ii-x (2007), <http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf> [hereinafter DISCLOSURE EFFICACY STUDY].

⁵¹ See Press Release, Fed. Reserve Bd. (May 23, 2007), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/20070523a.htm> (announcing the issuance for public comment of the proposed amendments to Regulation Z).

that were tested in the study and adopted by the Federal Reserve in the proposed revisions to Regulation Z did not completely eliminate consumer mistakes.⁵² Finally, the study concludes by noting that a significant number of consumers “lack fundamental understanding of how credit card accounts work.”⁵³

Mortgage products raise the same concerns. A recent FTC survey found that many consumers do not understand, or even identify, key mortgage terms.⁵⁴ Survey evidence suggests that some consumers with fixed rate mortgages (FRMs) do not know the interest rates on their mortgages.⁵⁵ A survey conducted by the Federal Reserve found that homeowners with adjustable rate mortgages (ARMs) were poorly informed about the terms of their mortgages.⁵⁶ The survey results showed that “[t]hirty-five percent of ARM borrowers did not know the value of the per-period cap on interest rate changes. Similarly, 44 percent of respondents . . . did not know the values of one or both of the two variables used to calculate the lifetime interest cap.”⁵⁷ Moreover, many consumers do not understand that rising interest rates can lead to increases in their ARM rate.⁵⁸ And a 2003 survey of financial

⁵² See DISCLOSURE EFFICACY STUDY, *supra* note 50 (comparing various proposed and current disclosure designs, and showing the proposed designs to be more effective, but not fully effective).

⁵³ See *id.*, at 52. Similarly, a recent study conducted by the Auriemma Consulting Group found that over 40% of respondents do not feel well informed about credit cards and their benefits before deciding to apply for a new card. See *Card Applications, CARDFLASH*, May 16, 2007, <http://www.cardweb.com/cardflash/2007/05/16/card-applications> (reporting that 58% of the over 400 respondents to the Auriemma survey felt well-informed about credit cards, and only one-third applied for new credit cards after researching other options).

⁵⁴ See JAMES M. LACKO & JANIS K. PAPPALARDO, FTC, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS chs. 3, 6 (2007), available at <http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf> (examining the efficacy of mortgage cost-disclosures through thirty-six in-depth interviews and a quantitative survey of over eight hundred mortgage customers). For example, 95% of respondents could not correctly identify the prepayment penalty amount, 87% could not correctly identify the total up-front charges amount, and 20% could not identify the correct APR amount. *Id.* at 79 tbl.6.6.

⁵⁵ Cf. Campbell, *supra* note 6, at 1584 (stating that about 7% of the questioned households reported “implausibly low mortgage rates”).

⁵⁶ See Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 26-27 (Fed. Res. Bd. of Governors, Fin. & Econ. Discussion Series, Paper No. 2006-03, 2006), available at <http://www.federalreserve.gov/Pubs/feds/2006/200603/200603pap.pdf> (concluding that “[b]orrowers with less income or education seem especially likely not to know their mortgage terms”).

⁵⁷ *Id.* at 19 (footnote omitted).

⁵⁸ *Id.*; see also Campbell, *supra* note 6, at 1584 n.27 (citing Bucks & Pence, *supra* note 56).

literacy in Washington State found that victims of predatory lending did not understand the cost of mortgages.⁵⁹ Focusing on closing costs, the Department of Housing and Urban Development (HUD) has concluded that “[t]oday, buying a home is too complicated, confusing and costly. Each year, Americans spend approximately \$55 billion on closing costs they don’t fully understand.”⁶⁰

Survey evidence on other consumer credit products similarly suggests that consumers are only imperfectly informed about the relevant characteristics and costs of these products. For example, payday-loan customers, while generally aware of finance charges, were often unaware of annual percentage rates.⁶¹ With respect to another consumer credit product, the tax-refund-anticipation loan, approximately 50% of survey respondents were not aware of the fees charged by the lender.⁶² Survey evidence also suggests that “[m]ost consumers do not understand what credit scores measure, what good and bad scores are, and how scores can be improved.”⁶³ Neither do they fully understand the implications of a low credit score.⁶⁴ More generally, a nationwide survey sponsored by the Consumer Federation of America found that 30% of Americans did not know what the letters “APR” stand for, and

⁵⁹ See DANNA MOORE, SURVEY OF FINANCIAL LITERACY IN WASHINGTON STATE: KNOWLEDGE, BEHAVIOR, ATTITUDES, AND EXPERIENCES (Wash. State Univ., Soc. and Econ. Scis. Research Ctr., Technical Report No. 03-39, Dec. 2003), *available at* <http://dfi.wa.gov/news/finlitsurvey.pdf> (finding that victims of predatory lenders have statistically significantly lower levels of financial knowledge than the general population), *cited in* Campbell, *supra* note 6, at 1585.

⁶⁰ News Release No. 05-091, U.S. Dep’t of Housing and Urban Dev., Jackson Unveils “Road to Reform” for American Homebuyers (June 27, 2005), <http://www.hud.gov/news/release.cfm?content=pr05-091.cfm>.

⁶¹ See Gregory Elliehausen, *Consumers’ Use of High-Price Credit Products: Do They Know What They Are Doing?* 29-30 (Networks Fin. Inst. at Ind. State Univ., Working Paper No. 2006-WP-02, May 2006) [hereinafter Elliehausen, *Consumers’ Use*] (“Eighty-five to 96.1 percent of payday loan customers reported accurate finance charges paid for their most recent payday loan. In contrast, only 20.1 percent of customers were able to report accurate annual percentage rate.” (footnote omitted)); GREGORY ELLIEHAUSEN & EDWARD C. LAWRENCE, CREDIT RESEARCH CTR., GEORGE WASH. UNIV., PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND 48-49 (2001), *available at* <http://www.business.gwu.edu/research/centers/fsrp/pdf/Mono35.pdf> (citing similar statistics).

⁶² Elliehausen, *Consumers’ Use*, *supra* note 61, at 31.

⁶³ Press Release, Consumer Fed’n of Am. & Providian, Most Consumers Do Not Understand Credit Scores According to a New Comprehensive Survey 1 (2004), *available at* <http://www.consumerfed.org/pdfs/092104creditscores.pdf>.

⁶⁴ See *id.* at 1-2.

63% did not understand that the APR was the primary indicator of a loan's cost.⁶⁵

Consumers who lack information about the basic operation of credit products, who do not understand annual percentage rates, or who do not know that they have been charged substantial fees, cannot make effective comparisons among products. Without comparison shopping, the ordinary discipline that drives markets toward efficiency is missing. Instead of facing informed consumers to whom they must offer the best, most competitive product, lenders can offer credit on onerous terms and compete instead by finding new ways to attract customers, such as clever radio ads or promises of cash rebates.

Other evidence also suggests that consumers have inadequate financial information. Many consumers do not know their credit scores.⁶⁶ Since the terms of credit products are often a function of the consumer's credit score, these consumers cannot accurately assess the costs associated with credit products, nor can they shop effectively for

⁶⁵ Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Finance Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 662 n.441 (2000); see also Diane Hellwig, Note, *Exposing the Loansharks in Sheep's Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense*, 80 NOTRE DAME L. REV. 1567, 1592 (2005) (citing Drysdale & Keest, *supra*) (discussing several consumer surveys revealing a lack of consumer knowledge regarding loan costs).

⁶⁶ A recent survey conducted by Capital One and Consumer Action found that 27% of respondents had never checked their credit report. See *Survey: 27% of Consumers Do Not Read Credit Reports*, CREDIT & COLLECTIONS WORLD, Oct. 5, 2006, <http://creditandcollectionsworld.com/article.html?id=20061016NIJPR6OI>. Another recent survey from Visa USA found that over 40% of respondents have never checked their credit score and that only 22% of respondents check their credit score once a year. See *Scores & Jobs*, CARDFLASH, Sept. 14, 2007, <http://www.cardweb.com/cardflash/2007/09/14/scores-jobs>. A 2003 survey commissioned by the Consumer Federation of America, and conducted by Opinion Research Corporation International, found that consumers lack essential knowledge about credit reporting and credit scores. See *Poll: Consumers Don't Understand Credit Reporting, Favor Reforms*, INS. J., Aug. 11, 2003, <http://www.insurancejournal.com/news/national/2003/08/11/31410.htm> (noting that most Americans do not understand what credit scores mean, how scores can be changed, or even how they can be obtained). See also U.S. GOV'T ACCOUNTABILITY OFFICE, CREDIT REPORTING LITERACY: CONSUMERS UNDERSTOOD THE BASICS BUT COULD BENEFIT FROM TARGETED EDUCATIONAL EFFORTS 10-11 (2005), available at <http://www.gao.gov/new.items/d05223.pdf> [hereinafter GAO, LITERACY REPORT] (reporting that, even though 70% of respondents correctly defined a credit score, less than one third had obtained their scores); Angela Lyons, Mitchell Rachlis & Erik Scherpf, *What's in a Score? Differences in Consumers' Credit Knowledge Using OLS and Quantile Regressions* 24-26 (Networks Fin. Inst. at Ind. State Univ., Working Paper No. 2007-WP-01, Jan. 2007) (analyzing data from the GAO's *Literacy Report*, *supra*, to identify demographics in the most need of financial education).

lower-cost credit products. Beyond the credit score itself, consumers are poorly informed about general credit-related issues. The mean Credit Knowledge Score obtained in a 2004 survey conducted by the GAO was 55 out of 100.⁶⁷ Many consumers also lack general information about bankruptcy law.⁶⁸ For consumers who are in financial difficulty, this information is critical to rational decision making. These data suggest that many consumers are imperfectly informed about the costs of financial distress and, indirectly, of credit products that might increase the likelihood of financial distress.⁶⁹ Finally, a growing literature on consumers' financial literacy shows that "providing financial information and education results in positive improvements in consumers' financial literacy levels."⁷⁰ These findings imply that there is room for improvement, or, put differently, that millions of consumers are making financial mistakes.

The impact of consumers' lack of information is made worse by the misinformation that many consumers hold. The 2002 Fannie Mae National Housing Survey found that over half of all African-American and Hispanic borrowers erroneously believed that lenders are required by law to provide the best possible loan rates.⁷¹ They might know that they did not fully understand mortgage rates, but their misplaced trust in lenders and mortgage brokers gave them false confidence that their lack of knowledge did not harm them. In such cases, market imperfections are magnified.

⁶⁷ GAO, LITERACY REPORT, *supra* note 66, at 84 fig.10.

⁶⁸ Press Release, Experian, Experian-Gallup Survey Shows Many Consumers Are Not Prepared for a Katrina-Like Disaster (Oct. 12, 2005), http://press.experian.com/press_releases.cfm (select "United States," "Consumer Credit," and "2005" from the pull-down menus) (summarizing data from the September 2005 Experian-Gallup Personal Credit Index survey).

⁶⁹ Another underappreciated cost of financial distress and, indirectly, of credit products follows from the effects of low credit scores on employability. A recent survey from Visa USA shows that only 20% of Americans know that it is legal for employers to refuse to hire job applicants with low credit scores. *Scores & Jobs*, *supra* note 66.

⁷⁰ See Lyons et al., *supra* note 66, at 4.

⁷¹ FANNIE MAE, THE GROWING DEMAND FOR HOUSING: 2002 FANNIE MAE NATIONAL HOUSING SURVEY 9 (2002), available at <http://www.fanniemae.com/global/pdf/media/survey/survey2002.pdf>.

2. Consumer Behavior

a. Credit Cards

Indirect, behavioral evidence reinforces a vision of poorly informed consumers.⁷² In a recent study, economists Haiyan Shui and Lawrence Ausubel identified mistakes in consumers' credit card choices. They found that a majority of consumers who accepted a credit card offer featuring a low introductory rate did not switch out to a new card with a new introductory rate after the expiration of the introductory period, even though their debt did not decline after the initial introductory period ended.⁷³ This is puzzling because a majority of consumers in the study received multiple pre-approved credit card offers per month and switching from one card to another would have entailed only a small transaction cost. With a common ten-percentage-point margin between introductory and postintroductory interest rates and an average balance of \$2,500, this mistake alone cost \$250 a year.⁷⁴

⁷² The studies summarized in this part focus on borrowing behavior. In addition, experimental evidence suggests that credit cards affect spending behavior. See Drazen Prelec & Duncan Simester, *Always Leave Home Without It: A Further Investigation of the Credit-Card Effect on Willingness to Pay*, 12 *MARKETING LETTERS* 5, 5-6, 10-11 (2001) (finding that the method of payment—credit card or cash—affects people's willingness to pay). See also GEORGE RITZER, *EXPRESSING AMERICA: A CRITIQUE OF THE GLOBAL CREDIT CARD SOCIETY* 60-62 (1995); Richard A. Feinberg, *Credit Cards as Spending Facilitating Stimuli: A Conditioning Interpretation*, 13 *J. CONSUMER RES.* 348, 349-55 (1986); Elizabeth C. Hirschman, *Differences in Consumer Purchase Behavior by Credit Card Payment System*, 6 *J. CONSUMER RES.* 58, 59, 62-64 (1979); Michael McCall & Heather J. Belmont, *Credit Card Insignia and Restaurant Tipping: Evidence for an Associative Link*, 81 *J. APPLIED PSYCHOL.* 609, 612 (1996); Dilip Soman, *Effects of Payment Mechanism on Spending Behavior: The Role of Rehearsal and Immediacy of Payments*, 27 *J. CONSUMER RES.* 460, 472 (2001).

⁷³ Haiyan Shui & Lawrence M. Ausubel, *Time Inconsistency in the Credit Market 9* (May 3, 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=586622>. The evidence shows that most consumers do not jump from one card to another and from one teaser rate to another. But detailed statistics are not necessary to reach this conclusion: it is evident from the fact that issuers offer teaser rates. Unless issuers have decided to forego interest revenues altogether, issuers would not offer teaser rates if most consumers did not stay beyond the introductory period. It is clear, however, that most issuers have not decided to forego interest revenues altogether. In fact, interest revenues represent 65% of issuers' total revenues. *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. 6 (2007) (statement of Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School).

⁷⁴ See Shui & Ausubel, *supra* note 73, at 8-9.

Shui and Ausubel also found that when faced with otherwise identical credit card offers, consumers prefer a credit card with a 4.9% teaser rate lasting for an introductory period of six months over a credit card with a 7.9% teaser rate lasting for an introductory period of twelve months. Consumers in this study carried an average balance of \$2,500 over a one-year period. Those who accepted the six-month introductory offer paid a postintroductory rate of 16% during the latter half of the year. These results indicate that at least some consumers were making a substantial mistake: consumers preferred the lower-rate, shorter-duration card even though they paid \$50 more in interest on this card than they would have with the longer-duration alternative.⁷⁵

What explains these mistakes? Why are consumers routinely paying more interest than they must? One possible explanation is that consumers systematically underestimate the amount that they will borrow, or at least the amount they will borrow on a specific card, in the postintroductory period. In other words, at the time they take out their cards, consumers are optimistic about their future credit needs, about their future willpower, about the likelihood that they will switch to a new card with a new, low introductory rate, or about all of the above.

A second possible explanation attributes a much higher level of sophistication to consumers. This explanation assumes that consumers are aware of their imperfect self-control and seek credit arrangements that would help them precommit to borrow less. A shorter introductory period can serve as a commitment device. If a consumer must borrow today but wishes to commit to borrow less in the future, that consumer may prefer a credit card that allows interest-free borrowing now but makes borrowing very expensive in the future (after the introductory period ends)—so expensive that the cost of borrowing will overcome any temptation to borrow.⁷⁶ The data show, however, that even if the preference for a shorter-period, lower-rate teaser was driven by a sophisticated attempt to purchase a precommitment device, this attempt failed. The extent of borrowing at the postintroductory rate implies a substantial level of optimism about the efficacy

⁷⁵ *See id.*

⁷⁶ *See id.* at 14-16. This precommitment argument assumes that borrowers cannot switch to another card with another introductory rate when the introductory rate on the first card expires. But, as mentioned above, new introductory offers are often available and switching costs are low.

of the commitment device. In other words, it implies that a large number of consumers were making a mistake.

The data used in the Shui and Ausubel study was taken from a randomized experiment conducted by a major credit card issuer in 1995. Such experiments are conducted to help issuers optimize their marketing strategies. The specific experiment analyzed by Shui and Ausubel provides clear guidance to the issuer's marketing department: offer lower introductory rates for shorter durations in order to increase both the number of customers and total interest revenues. As this research shows, exploitation of consumer error is an effective way to boost profits.

Another recent study, by David Gross and Nicholas Souleles, provides further evidence of seemingly irrational consumer behavior. The most striking data show that many consumers pay high interest rates on large credit card balances while holding liquid assets that yield low returns. Specifically, more than 90% of consumers with credit card debt have some very liquid assets in checking and savings accounts. The amounts in question are often substantial: one-third of credit card borrowers hold more than one month's income in these liquid assets. With a median balance of more than \$2,000 for consumers who have a balance, and a spread of over ten percentage points between credit card interest rates and the interest rates obtained on assets in checking and savings accounts, a typical consumer is losing more than \$200 per year in interest payments that could have been easily avoided.⁷⁷

Sumit Agarwal, Souphala Chomsisengphet, Chunlin Liu, and Nicholas S. Souleles developed a study using a unique market experiment conducted by a large U.S. bank to assess how systematic and costly consumer mistakes are in practice.⁷⁸ In 1996, the cooperating bank offered consumers a choice between two credit card contracts: one with an annual fee and a lower interest rate, and one with no annual fee and a higher interest rate. As the authors explain, "[t]o minimize their total interest costs net of the fee, consumers expecting to borrow a sufficiently large amount should select the fee card, and vice-versa" for those not planning to borrow.⁷⁹ Even though the

⁷⁷ See David B. Gross & Nicholas S. Souleles, *Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data*, 117 Q.J. ECON. 149, 180 (2002).

⁷⁸ Agarwal et al., Credit Contracts *supra* note 18.

⁷⁹ *Id.*

choice between the two contracts was especially simple, the authors found that about 40% of consumers chose the wrong contract.⁸⁰ On the bright side, the authors found that “the probability of choosing the sub-optimal contract declines with the dollar magnitude of the potential error,” and that “those who made larger errors in their initial contract choice were more likely to subsequently switch to the optimal contract,” implying that the observed mistakes were not very costly.⁸¹ Nonetheless, the evidence of errors is striking in what is, again, a very simple decision.

Stephan Meier and Charles Sprenger compare time-preference data from a field experiment with a “targeted group of low-to-moderate income consumers,” with credit report data on these consumers.⁸² The authors find that consumers who exhibit hyperbolic discounting and dynamically inconsistent intertemporal choices borrow more, and specifically borrow more on their credit cards.⁸³ This result suggests that “individuals borrow more . . . than they actually would prefer to borrow given their long-term objectives.”⁸⁴ The data may also suggest that those most prone to error are those borrowing the most, which means that the impact of errors is exacerbated both for the individual and for the marketplace.

A study by Sumit Agarwal, John C. Driscoll, Xavier Gabaix, and David Laibson was based on two separate proprietary datasets from large financial institutions. The first dataset contained a representative random sample of about 128,000 credit card accounts followed monthly over a 36-month period (from January 2002 through December 2004). The study found that more than 28% of customers made mistakes that triggered fees, including late fees, overlimit fees, and

⁸⁰ *Id.* at 4. Namely, given ex post borrowing patterns, these consumers would have saved money by choosing the alternative contract. Of course, in theory, given the possibility of ex post shocks, consumers that chose the incorrect contract ex post might still have made the optimal choice ex ante. The authors test for and reject the ex post shock explanation, concluding that these consumers did not make the optimal ex ante choice. *Id.* at 9-10.

⁸¹ *Id.* at 5.

⁸² See Stephan Meier & Charles Sprenger, *Impatience and Credit Behavior: Evidence from a Field Experiment* 2-3 (Fed. Reserve Bank of Boston, Working Paper No. 07-3, 2007), available at <http://www.bos.frb.org/economic/wp/wp2007/wp0703.pdf>.

⁸³ *Id.* at 24.

⁸⁴ *Id.* at 3. The authors also find that high levels of impatience, represented by a low long-run discount factor, explain account delinquencies and slow debt repayment patterns. *Id.* at 25.

cash-advance fees.⁸⁵ The authors consider fee payment a mistake, because “fee payment can often be avoided by small and relatively costless changes in behavior.”⁸⁶ The second dataset contained 14,798 accounts which accepted balance-transfer offers over the period January 2000 through December 2002. The authors found that more than one-third of consumers made mistakes in using the balance-transfer option. For example, instead of making new credit card charges on other available cards, these consumers charged purchases to the teaser rate cards. This was a mistake because teaser rates apply only to transferred balances, and the interest rate on new purchases is higher than the interest rate charged on the old credit card.⁸⁷ The impact of the mistake is intensified by the fact that the customer’s payments are allocated first to the teaser-rate transfer balance, so that the higher-rate new purchases accrue interest for the longest possible period of time.

Nadia Massoud, Anthony Saunders and Barry Scholnick documented evidence that consumers unnecessarily incur late fees and overlimit fees, even though they had enough money in their deposit accounts to avoid these costs (accounting for the possibility that funds in deposit accounts are being held as precautionary balances). The study constructs a novel dataset covering almost 90,000 individuals. Analysis of these data shows that even these easily avoided mistakes—mistakes due to inattention or carelessness—are made by significant numbers of consumers. Specifically, 4% of consumers fail to make the minimum payment even though they have sufficient funds in their deposit accounts (after leaving a precautionary balance). And 1.7% of consumers exceed their credit limit when they could have paid the excess amount from their deposit accounts.⁸⁸

It is notable that researchers have tested only the most obvious and unambiguous mistakes. The data show substantial error rates for the simplest credit decisions. In the credit card area, more complex credit decisions remain untested.

⁸⁵ Agarwal et al., *Age of Reason* *supra* note 18 25 fig.13. The frequency of fee payment was lower for consumers in their forties and fifties (approximately 28%) and higher for younger and older consumers (up to 35%). *Id.*

⁸⁶ *Id.* at 23.

⁸⁷ *Id.* at 26-28 fig.15. Again the frequency of mistake was lower for consumers in their forties and fifties (approximately 27%) and higher for younger and older consumers (almost 50%). *Id.*

⁸⁸ Nadia Massoud, Anthony Saunders & Barry Scholnick, *Who Makes Credit Card Mistakes?* 15 tbl.1 (Aug. 2007) (unpublished manuscript), *available at* http://www.philadelphiafed.org/econ/conf/consumercreditandpayments2007/papers/Scholnick_Who_Makes_Credit_Card_Mistakes.pdf.

b. *Mortgage Loans*

Mortgage loans represent a different borrowing environment. On the one hand, such loans are far more complex than typical credit cards, undoubtedly increasing the opportunities for errors. And the fact that consumers enter into fewer mortgage contracts than credit card contracts decreases the opportunities for learning. On the other hand, consumers know that a great deal is at stake (and that they make these transactions only rarely), which might encourage more vigilance and, as a result, fewer errors. The data suggest that errors are prevalent in this financial market.

Subprime home equity loans offer an example. Such loans are typically targeted at low-income borrowers. For these borrowers, a higher risk of default may justify higher, subprime interest rates. The data show, however, that a substantial number of middle-income families (and even some upper-income families) with low default risk sign up for subprime loans. Because these families qualify for prime-rate loans, these data indicate a very costly mistake on the part of these middle-income borrowers.

In 2002, researchers at the National Training and Information center (NTIC) concluded that at least 40% of those who were sold high interest rate, subprime mortgages would have qualified for prime-rate loans.⁸⁹ Freddie Mac and Fannie Mae estimate that between 35% and 50% of borrowers in the subprime market could qualify for prime-market loans.⁹⁰ A study by the Department of Housing and Urban Development of all mortgage lenders revealed that 23.6% of middle-income families (and 16.4% of upper-income families) who refinanced a home mortgage in 2000 ended up with a high-fee, high-interest subprime mortgage.⁹¹ A study conducted for the Wall Street

⁸⁹ See Lew Sichelman, *Community Group Claims CitiFinancial Still Predatory*, ORIGINATOR NEWS, Jan. 2002, at 25 (reporting on new claims of CitiFinancial's predatory practices after settlements with state and federal regulators).

⁹⁰ See James H. Carr & Lopa Kolluri, *Predatory Lending: An Overview*, in FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: ISSUES AND ANSWERS 31, 37 (Fannie Mae Found. ed., 2001) (suggesting that default risk alone does not fully explain the size of the subprime market); see also Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 730 (2006) (using borrowers' credit history and loan profile in support of the estimation that, at times, 50% of borrowers with subprime loans actually were qualified for prime loans).

⁹¹ Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending*, at tbl.B.3 (U.S. Dep't of Hous. & Urban Dev. Hous. Fin. Working Paper Series, Working Paper No. HF-014, 2002), available at <http://www.huduser.org/Publications/pdf/workpapr14.pdf>.

Journal showed that from 2000 to 2006, 55% of subprime mortgages went to borrowers with credit scores that would have qualified them for lower-cost prime mortgages.⁹² By 2006, that proportion had increased to 61%.⁹³ Neither of these studies is definitive on the question of overpricing because they focus exclusively on FICO scores, which are critical to loan pricing but are not the only factor to be considered in credit-risk assessment. Nonetheless, the high proportion of people with good credit scores who ended up with high-cost mortgages raises the specter that some portion of these consumers were not fully cognizant of the fact that they could have borrowed for much less. This conclusion is further corroborated by studies showing that subprime mortgage prices cannot be fully explained by borrower-specific and loan-specific risk factors.⁹⁴

What went wrong? The Wall Street Journal points to one possibility: mortgage brokers received 27% higher fees for originating subprime mortgages than for originating conforming loans.⁹⁵ In addition, the complexity of the subprime mortgage products was such that the average borrower had little chance of understanding the costs associated with an offered mortgage, let alone comparing costs across several products.⁹⁶ The market clearly failed these consumers, causing

⁹² Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit Worthy: As Housing Boomed, Industry Pushed Loans to a Broader Market*, WALL ST. J. Dec. 3, 2007, at A1 (citing a study by First American LoanPerformance).

⁹³ *Id.*

⁹⁴ See, e.g., REN S. ESSENE & WILLIAM APGAR, JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV., UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 2 (2007), available at http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf (citing ALLEN J. FISHBEIN & PATRICK WOODALL, CONSUMER FEDERATION OF AMERICA, EXOTIC OR TOXIC? AN EXAMINATION OF THE NON-TRADITIONAL MORTGAGE MARKET FOR CONSUMERS AND LENDERS 24 (2006), available at http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf (finding that the borrower's race affects the likelihood of receiving a subprime mortgage)).

⁹⁵ See Brooks & Simon, *supra* note 92 (reporting the findings of Wholesale Access, a mortgage research firm, which discovered that U.S. mortgage brokers collected 1.88% of the loan amount as a fee for originating a subprime loan, as opposed to 1.48% for a prime mortgage); see also Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, § 3 (describing, based on interviews with former employees and on internal documents, how Countrywide created incentives for brokers and sales representatives to steer borrowers into higher-priced loans and; at the same time these representatives would promise borrowers: "I want to be sure you are getting the best loan possible").

⁹⁶ See Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. (forthcoming 2009) (manuscript at 4), available at <http://law.bepress.com/alea/18th/art47> (follow "Download the Paper" hyperlink)

them to pay far more for credit than they could have qualified for—if only they had known how to shop.

The welfare implications of these mistakes are significant. As noted in the CFA/Providian Study:

[A]ccording to Fair Isaac's website, on a \$150,000, 30-year, fixed-rate mortgage, consumers with credit scores over 720 will be charged a 5.72% rate with monthly payments of \$872, while consumers with credit scores below 560 will be charged a 9.29% rate with monthly payments of \$1,238 (if in fact they are able to qualify for the loan)—an annual difference of \$4,392.⁹⁷

Lauren Willis finds that, with an average APR difference of three to four points between prime and subprime loans, a prime borrower taking a \$100,000 thirty-year subprime loan will pay over \$200 per month more than necessary, which amounts to over \$70,000 in unjustified charges over the life of the loan.⁹⁸

While the evidence of prime consumers taking subprime loans is most striking, costly mistakes can also be documented among subprime borrowers. Patricia McCoy, in a recent article, documents the prevalence of imperfect information in the subprime mortgage market. She describes marketing and contracting practices employed by subprime lenders to minimize consumers' ability to shop for lower interest rates.⁹⁹ Susan Woodward, analyzing more than 7500 FHA loans

(describing the complexity of subprime mortgage contracts and how it inhibits competition); Willis, *supra* note 90, at 726-27 (arguing that by creating different mortgage products for borrowers in similar financial situations, sophisticated lenders create significant barriers to meaningful consumer participation in an efficient mortgage market).

⁹⁷ Consumer Fed'n of Am. & Providian, *supra* note 63, at 2.

⁹⁸ Willis, *supra* note 90, at 729. This picture becomes grimmer when comparing prime loans to subprime loans with the not uncommon APRs of 20%, 30%, and higher. See *id.* ("In 2003, a year when prime rates averaged less than 6% and points and fees averaged about 0.50%, Citigroup, Wells Fargo, and Household, all major U.S. lenders, reported originating subprime loans with APRs exceeding 20%, and Household originated loans with APRs in excess of 30%."). As compared to a \$100,000 thirty-year prime loan, a 20% subprime loan will cost the consumer over \$1,000 extra each month and over \$370,000 extra in total. *Id.* Putting these figures into perspective, Elizabeth Warren and Amelia Warren Tyagi conclude that, had the prime household "gotten a traditional [prime] mortgage instead [of a 20% subprime mortgage], they would have been able to put two children through college, purchase half a dozen new cars, and put enough aside for a comfortable retirement." See ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE* 134 (2003).

⁹⁹ Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 123 (2007); see also Willis, *supra* note 90, at 726-28 (explaining the difficulties facing consumers in fully understanding their mortgage contract options). As

(not the typical subprime loans, but often targeting similarly higher-risk borrowers), found that borrowers overpay by thousands of dollars in fees, due to excessive complexity, which prevents effective comparison-shopping and hinders competition.¹⁰⁰ Eric Stein estimated that the sum of interest and fees charged on predatory loans, at levels above what a competitive market would produce, costs affected U.S. consumers \$9.1 billion annually, an average of \$3,370 per subprime loan household per year.¹⁰¹

Additional evidence of consumer mistakes is provided by data on foreclosure rates. Subprime foreclosure rates range from 20% to 30%.¹⁰² Foreclosure costs a family its home and everything invested in the home up to that point, along with the costs of relocating and moving to new housing. A foreclosure seriously impairs credit ratings, increasing all credit costs and reducing the likelihood of owning a home again. Moreover, foreclosure is only the official tip of a serious housing problem. Instead of hanging on for a formal foreclosure, many families that can no longer make payments on their homes move out, handing the keys over to the lender, sometimes in return for the lender's agreement not to pursue a deficiency judgment against them. If 20% to 30% of mortgages are in formal foreclosure, the number of families with subprime loans who are unable to hang on to their homes is likely to be considerably higher.

It is clearly possible for a rational, informed consumer to take on a high-cost subprime mortgage with the understanding that adverse contingencies might lead to default and foreclosure. Nonetheless, the high rate of foreclosures in the subprime market suggests that not all consumers knowingly assumed such a high risk of foreclosure. A recent study by Ren Essene and William Apgar concluded that "consumers have a limited ability to evaluate complex mortgage products

a result, subprime borrowers paid prices higher than what their risk profile justified. See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2058 (2007) (citing Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 *HOUSING POL'Y DEBATE* 533, 569 (2004)).

¹⁰⁰ SUSAN E. WOODWARD, A STUDY OF CLOSING COSTS FOR FHS MORTGAGES, at x, 57-69 (2008), available at http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf.

¹⁰¹ ERIC STEIN, COAL. FOR RESPONSIBLE LENDING, QUANTIFYING THE COST OF PREDATORY LENDING 2-3 (2001), available at <http://www.responsiblelending.org/pdfs/Quant10-01.pdf>. The number of borrowers was calculated by adding up the number of borrowers affected by the various methods of predatory lending, which included equity-stripping methods (financed credit insurance, exorbitant up-front fees, subprime prepayment penalties) and rate-risk disparities.

¹⁰² Willis, *supra* note 90, at 731-32 (summarizing studies).

and they often make choices which they regret after the fact.”¹⁰³ In response to the rising foreclosure rates, the Federal Reserve Board, prompted by voices within the industry and in Congress, has recently proposed regulations that would tighten lending standards.¹⁰⁴

The critical role of framing effects provides further evidence of imperfect rationality: a 2004 FTC study evaluated the effects of a new proposal by HUD requiring disclosure of payments from lenders to brokers for loans with above-par interest rates. Participants were shown cost-disclosure forms for two loans—one from a broker and one from a direct lender—and asked which was less expensive. The findings were striking. When the broker loan was less expensive than the lender loan, approximately 90% of respondents in the control groups (who did not view the new disclosure) correctly identified the less expensive loan. In contrast, when respondents were shown the new disclosure, only about two-thirds of consumers correctly identified the less expensive loan. The results were even more dramatic when the broker loan and direct-lender loan cost the same. In this set of experiments, the new broker disclosure reduced correct cost comparisons by roughly forty-four percentage points. Moreover, when these respondents were asked which mortgage they would choose, they revealed a significant bias against mortgages generated by brokers. Overall, the authors concluded that “[i]f the disclosure requirement has an impact similar to the magnitude found in one of the hypothetical loan cost scenarios examined in the study, the disclosures would lead mortgage customers to incur additional costs of hundreds of millions of dollars per year.”¹⁰⁵

A recent study by Sumit Agarwal, John C. Driscoll, Xavier Gabaix, and David Laibson, using records on 75,000 home equity loans made in 2002, identified persistent consumer mistakes in loan applications.

¹⁰³ ESSENE & APGAR, *supra* note 94, at i. Essene and Apgar further note that “the recent rise in mortgage delinquencies and foreclosures suggests that some households are taking on debt that they have little or no capacity to repay . . . [And/or they are] taking out mortgages . . . that are not suitable for their needs.” *Id.* They suggest that lenders are exploiting consumer mistakes, noting, for example, that some mortgage marketing and sales efforts “exploit consumer decision making weaknesses.” *Id.* at i-ii.

¹⁰⁴ Truth in Lending, 73 Fed. Reg. 1671 (proposed January 9, 2008) (to be codified at 12 C.F.R. pt. 226) (applying new protections to mortgage loans secured by a consumer’s principal dwelling, including a prohibition on lending based on the collateral without regard to the consumer’s ability to repay).

¹⁰⁵ JAMES M. LACKO & JANIS K. PAPPALARDO, FTC, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT, at ES-7 (2004).

In particular, consumer mistakes in estimating home values increased the loan-to-value ratio and thus the interest rate charged. Such mistakes increase the APR by an average of 125 basis points for home equity loans and 150 basis points for home equity lines of credit.¹⁰⁶ While only 5% of borrowers in their forties and fifties made “rate-changing mistakes,” more than 40% of younger and older borrowers made these mistakes, with the likelihood of mistakes reaching 80% for some age groups.¹⁰⁷

Another study identified repeated mistakes leading to excessive broker fees. In particular, this study found that consumers with a college education are able to save \$1500 on average by making fewer mistakes.¹⁰⁸ Finally, numerous studies have identified continuing mistakes in refinancing decisions. Many consumers fail to exercise options to refinance their mortgages, and thereby end up with rates that are substantially higher than the market rate.¹⁰⁹ Other consumers refinance too early, failing to account for the possibility that interest rates will continue to decline. According to one estimate, these refinancing mistakes can cost borrowers tens of thousands of dollars or up to 25% of the loan’s value.¹¹⁰

For most families, buying a home is the single most important financial decision of their lives. More money is at stake than in any other household transaction. And yet the data show that consumers make errors that collectively cost them billions of dollars.

¹⁰⁶ Agarwal et al., *supra* note 18, at 10.

¹⁰⁷ *Id.* at 12 fig.6, 13 fig.7.

¹⁰⁸ Susan Woodward, *Consumer Confusion in the Mortgage Market* 22 (Sand Hill Econometrics, Working Paper, July 14, 2003), available at http://www.sandhillecon.com/pdf/consumer_confusion.pdf, cited in Campbell, *supra* note 6, at 1589.

¹⁰⁹ See Campbell, *supra* note 6, at 1579, 1581, 1590; see also Robert Van Order et al., *The Performance of Low Income and Minority Mortgages* 33-34 (Ross Sch. of Bus. Working Paper Series, Working Paper No. 1083, 2007), available at <http://ssrn.com/abstract=1003444>. Similar mistakes have been identified in the U.K. See Campbell, *supra* note 6, at 1588 (citing DAVID MILES, THE UK MORTGAGE MARKET: TAKING A LONGER-TERM VIEW, INTERIM REPORT: INFORMATION, INCENTIVES, AND PRICING 53-60 (2003)) (noting that many consumers in the U.K. fail to refinance their mortgages when they become automatically adjusted to significantly higher rates).

¹¹⁰ See SUMIT AGARWAL, JOHN C. DRISCOLL & DAVID LAIBSON, OPTIMAL MORTGAGE REFINANCING: A CLOSED FORM SOLUTION 26, 29 (2008), available at <http://ssrn.com/abstract=1010702> (“[M]arket data . . . shows that many households did refinance too close to the [net present value (NPV)] break-even rule during the last 15 years . . .”). Following the NPV rule, instead of the optimal refinancing rule, leads to substantial expected losses: \$26,479 on a \$100,000 mortgage, \$49,066 on a \$250,000 mortgage, \$86,955 on a \$500,000 mortgage, and \$163,235 on a \$1,000,000 mortgage.

c. *Payday Loans*

Payday loans provide another example of a credit product that can impose substantial costs on imperfectly informed and imperfectly rational borrowers. This consumer credit product is designed as a short-term cash advance offered at a fee. In a typical transaction, a consumer might pay a \$30 fee for a two-week \$200 cash advance.¹¹¹ The fee structure of payday loans makes it difficult for consumers to compare directly the costs associated with a payday loan to the costs associated with other consumer credit products. In the typical payday loan described above, the \$30 fee corresponds to an annual interest rate of almost 400%.¹¹²

The collective effect of paying \$30 for small financial transactions is large, but a single \$30 fee is unlikely to bankrupt any consumer. The problem lies with the substantial subset of consumers who take out multiple advances and pay the \$30 fee many times over. A customer who misestimates her ability to repay the loan in fourteen days will likely roll the loan over for another fourteen days. Payday lenders target such customers, amassing 90% of their profits from borrowers who roll over their loans five or more times during a year.¹¹³ The Cen-

¹¹¹ See Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 857 (2007). A study by the Department of Defense documents payday loans carrying effective annual interest rates of up to 780%. See DOD, REPORT ON PREDATORY LENDING, *supra* note 3, at 10.

¹¹² Mann & Hawkins, *supra* note 111, at 857.

¹¹³ KEITH ERNST, JOHN FARRIS & URIAH KING, CTR. FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING 2 (2004), available at <http://www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf>; URIAH KING, LESLIE PARRISH & OZLEM TANIK, CTR. FOR RESPONSIBLE LENDING, FINANCIAL QUICKSAND: PAYDAY LENDING SINKS BORROWERS IN DEBT WITH \$4.2 BILLION IN PREDATORY FEES EVERY YEAR 6 (2006), available at http://www.responsiblelending.org/pdfs/rr012-Financial_Quicksand-1106.pdf; see also Paul Chessin, *Borrowing from Peter To Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*, 83 DENV. U. L. REV. 387, 411 (2005) (finding that about 65% of loan volume in Colorado comes from customers who borrow more than twelve times a year); Flannery & Samolyk, *Payday Lending: Do the Costs Justify the Price?* 12-13 (FDIC Center for Financial Research, Working Paper No. 2005-09, 2005) (indicating that between 24% and 30% of customers at payday loan stores borrowed more than 12 times per year). A \$30 fee may be required to cover the costs to the lender of an initial payday-loan transaction. The cost of rolling over an existing loan is, however, substantially lower. The existence of non-profit payday lenders who charge substantially lower fees suggest that for-profit lenders are charging more than is necessary to cover their costs. See John Leland, *Nonprofit Payday Loans? Yes, to Mixed Reviews*, N.Y. TIMES, Aug. 28, 2007, at A14 (noting the existence of many lower nonprofit payday loan providers, some of which charge half the fees of commercial payday lenders).

ter for Responsible Lending (CRL) estimates that consumers pay an extra \$4.2 billion each year in excess fees on payday loans.¹¹⁴

A Department of Defense (DoD) study has shown that payday lenders prey on members of the military community as a lucrative market.¹¹⁵ The DoD study found that borrowers take on a payday loan when they can get a lower-interest nonpayday loan, for example, from the Military Aid Societies or from the banks and credit unions on military installations.¹¹⁶ Another recent study, by Sumit Agarwal, Paige Skiba, and Jeremy Tobacman, found that a majority of payday loan applicants had more than \$1000 available in liquid assets.¹¹⁷ While paying a 400% interest rate may be rational, absent other options, under conditions of extreme financial distress, it is very difficult to rationalize when the borrower can draw on substantial liquid assets.

¹¹⁴ KING, PARRISH & TANIK, *supra* note 113, at 9-10. The \$4.2 billion figure assumes that any fee for the fifth rollover and beyond are excess fees, reflecting the CRL's position that a business model relying on multiple rollovers is exploitative (especially since many borrowers underestimate the number of rollovers and the resulting costs). While we cannot evaluate the CRL's calculation and the resulting \$4.2 billion figure, the cited figure is suggestive of the magnitude of the welfare costs involved.

¹¹⁵ DOD, REPORT ON PREDATORY LENDING, *supra* note 3, at 4.

¹¹⁶ The government has begun organizing Military Aid Societies to provide better options and a safety net for Service members and their families in need of emergency funds.

Whereas there may be few alternatives for the average consumer with bad credit to obtain cash, there is a safety net available for Service members and their families outside of high interest loans. . . . Additionally, the banks and credit unions located on military installations have begun to provide lending products that fulfill the need for quick cash.

Id. at 29. The "Army Emergency Relief (AER), the Navy-Marine Corps Relief Society (NMCRS) and the Air Force Aid Society (AFAS) . . . are chartered expressly to assist Service members and their families who have financial crises." *Id.* Such products include providing small, short-term loans at reasonable rates, often with a requirement that borrowers must obtain additional financial education. Loan amounts are limited \$500 or less, with APRs of 11.5% to 18%, and provide between two weeks and six months to pay. *Id.* at 31-34. "In 2005, the Aid Societies provided . . . [.] either through no-interest loans or grants," an average support per case of between \$808 and \$917. *Id.* at 30.

¹¹⁷ See Sumit Agarwal, Paige Marta Skiba & Jeremy Tobacman, How Do Consumers Choose Between Credit Cards and Payday Loans? 2-3 (Feb 15, 2008) (unpublished manuscript, on file with author) (finding, based on a dataset of loan records from a large payday lender and a matched dataset of transactions and credit histories at a financial institution, that 3,000 of the 4584 payday loan applicants had more than \$1000 in available liquidity).

3. Product Design

The evidence described above strongly suggests that imperfect information and imperfect rationality pervade credit product markets. Another category of behavioral evidence reinforces the same conclusion. These data focus on seller behavior, specifically on evidence of how sellers design their credit products. In many cases, sellers design their products to exploit consumers' imperfect information and imperfect rationality. Observing such product designs provides powerful evidence of the prevalence of these imperfections.¹¹⁸

a. Credit Cards

i. Long-Term Interest Rates

Changes in the credit card contract illustrate the growing sophistication of card issuers in exploiting consumer imperfections. Until recently, credit card interest rates (standard APRs) were exceptionally high. The reason, as admitted by economists who worked as Visa consultants, was that issuers felt that demand for their product was not sensitive to this price dimension.¹¹⁹ Consumers, at the time, were focusing on annual fees, not on long-term interest rates. One explanation is that consumers optimistically believed that they would not borrow, or would not borrow as much, in the long run. As a result, they focused on the annual fee—which they would pay regardless of the amount they borrowed—rather than the interest rate which implied far greater costs, but only for those consumers who carried a balance. A lender could significantly increase profits by dropping the annual fee and raising interest rates. More recently, long-term interest rates have become more salient to consumers, perhaps reflecting their growing concern over rising balances on credit cards. The design of the credit card product changed in response. Long-term interest rates were reduced to attract and retain customers, as other charges were increased.

¹¹⁸ Bar-Gill, *supra* note 15, at 1375-79.

¹¹⁹ Evans and Schmalensee describe the credit card issuers' "view that the overall demand for credit is relatively insensitive to interest rates, a view supported by at least one empirical study and considerable folklore within the industry." DAVID S. EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 167 (1999).

ii. Penalty Fees and Rates

When interest rates became salient, competition focused on the interest rate dimension, and revenues from finance charges dropped accordingly. But credit card issuers did not simply forego revenues. Instead, they began to increase penalty fees and rates, which remain largely invisible to consumers.¹²⁰ For example, the average late fee rose from \$12.83 in 1995 to \$33.64 in 2005.¹²¹ The average overlimit fee on cards in 2005 was \$30.18, going as high as \$39.¹²² Penalty fees are the fastest growing source of revenue for issuers.¹²³ Of the \$24 billion in credit card fees that U.S. card holders paid in 2004,¹²⁴ penalty fees totaled \$13 billion a year¹²⁵ and accounted for 12.5% of issuers' revenues.¹²⁶

¹²⁰ In *Beasley v. Wells Fargo Bank, N.A.*, the bank's "Credit Card Task Force" proposed increasing "late" and "overlimit" fees as a "good source of revenue." 1 Cal. Rptr. 2d 446, 448 (Cal. Ct. App. 1991). Penalty fees are perceived as a "good source of revenue" because the industry perceives that "there (are) very few cardholders that switch cards because the late fee is too high." See *Credit Card Fees Soar Again*, CNNMONEY, Aug. 18, 1998, http://money.cnn.com/1998/08/18/banking/q_bankrate (quoting Peter Davidson, Executive Vice President, Speer & Assocs, Atlanta).

¹²¹ GAO, INCREASED COMPLEXITY REPORT, *supra* note 18, at 18. Issuers have also been imposing cutoff times on the due dates, which have increased the likelihood that a payment is considered late. See *2005 Credit Card Survey*, CONSUMER ACTION NEWS (S.F. Consumer Action, S.F., Cal.), Summer 2005, at 2, available at http://www.consumer-action.org/news/articles/2005_credit_card_survey/ (finding that 34% of the forty-seven surveyed issuers set cutoff times).

¹²² See GAO, INCREASED COMPLEXITY REPORT, *supra* note 18 (finding that overlimit fees on fixed interest rate cards had increased by an average of 6.5%, and overlimit fees on variable-rate cards had increased by 6%). It should be emphasized that issuers allow continued use of a credit card, even when the cardholder is over her limit.

¹²³ Penalty fees have been growing rapidly since 1996, when the Supreme Court allowed issuers to apply the lax or nonexistent limitations on fees from their home state to borrowers in other states (exportation), thus effectively deregulating late and overlimit fees. See *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 737, 747 (1996); see also TAMARA DRAUT & JAVIER SILVA, BORROWING TO MAKE ENDS MEET: THE GROWTH OF CREDIT CARD DEBT IN THE '90S 35 (2003), available at <http://www.demos.org/pub1.cfm> (stating that late fees are the fastest growing source of revenues for issuers); Bob Herbert, *Caught in the Credit Card Vise*, N.Y. TIMES, Sept. 22, 2003, at A17 (illustrating the effect of increased late fees, "the fastest growing source of revenue for the industry," on consumers (quoting DRAUT & SILVA, *supra*)).

¹²⁴ *2005 Credit Card Survey*, *supra* note 121, at 10.

¹²⁵ Nadia Massoud et al., *The Cost of Being Late: The Case of Credit Card Penalty Fees* 2-3 (Am. Fin. Ass'n, 2007 Chicago Meetings Paper, 2006), available at <http://ssrn.com/abstract=890826>; see also NAT'L CONS. LAW CTR., TRUTH IN LENDING 27 (4th ed. Supp. 2002) ("Over-limit fees are a major source of revenue for many credit card issuers.").

¹²⁶ Visa and MasterCard credit card issuers' total revenue was \$103.4 billion in 2004. Jeffrey Green, *C&P's 2006 Bank Card Profitability Study & Annual Report*, CARDS & PAYMENTS, May 2006, at 30, 31.

The cost to consumers of penalty fees and rates rose significantly with the advent of “universal default.”¹²⁷ Universal default clauses cause cardholders’ rates to increase (by an average of 6%) when the cardholder takes certain actions, such as applying for a mortgage, and having too much credit available.¹²⁸ A credit card company often doubles or triples interest rates when a cardholder’s credit score drops.¹²⁹ Consumers are imperfectly aware of the range of events that can trigger universal default and of the magnitude of the default interest rates. Even savvy consumers who actively seek disclosures from credit card companies often find the process difficult and exasperating. The information given is frequently unclear, obfuscated, or “lacking in key details about conditions, especially those related to fees and other costs, and to the circumstances that trigger universal default rules.”¹³⁰ Even the Office of the Comptroller of the Currency (OCC) recognized the problem and issued an advisory letter instructing national banks to disclose fully and prominently events that could result in an increase in APR.¹³¹

Moreover, to be effective, the timing of information is crucial. “Advance notice of default or penalty rate increases is not required by law. In many cases, the first time consumers learn of a rate increase is when they open their statements.”¹³² A warning, however, does not

¹²⁷ Recently, in response to mounting criticism, Citibank took the lead in stopping the universal default practice. See *Citi Stops Universal Default*, CARDLINE, Mar. 1, 2007.

¹²⁸ See 2005 *Credit Card Survey*, *supra* note 121, at 1 (listing several events that can trigger a universal default rate).

¹²⁹ *Id.*

¹³⁰ *Id.* Universal default “tops the list of unfair practices because customers are given little choice about the rate or fee hikes.” *Id.* (internal quotation marks omitted).

¹³¹ OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC ADVISORY LETTER 2004-10, CREDIT CARD PRACTICES (Sept. 14, 2004), available at <http://www.occ.treas.gov/Advlst04.htm>.

¹³² 2005 *Credit Card Survey*, *supra* note 121, at 1. Regulation Z does require credit card companies to send written notices to affected cardholders of any rate-term changes at least 15 days before such change becomes effective. GAO INCREASED COMPLEXITY REPORT, *supra* note 18, at 26. This disclosure, however, has proven to be ineffective, if only because the consumer is informed about the rate increase after completing the act that triggered the rate increase. A GAO study asserted that credit card companies have generally ceased practicing universal default based on the idea that the six largest issuers and twenty-five of twenty-eight popular large-issuer cards generally do not automatically raise interest rates if cardholders made a late payment to another creditor. *Id.* Yet many of these same issuers have not changed their practice of raising interest rates, merely providing notice to cardholders of triggering circumstances either in their disclosures or immediately prior to a rate hike. *Id.* at 24-25. The FRB is

mean that consumers will be able to pay off or transfer their existing balances. As a result, many will be unable to avoid paying additional penalty fees imposed by a universal default rate hike.¹³³ And, from an ex ante perspective, even consumers who are aware of the universal default clause might overestimate their ability to avoid the rate increase. In sum, when getting a new credit card consumers are likely to underestimate the risks associated with universal default.¹³⁴ The prevalence of universal default clauses can be explained, at least in part, as a strategic response by issuers to this underestimation bias.¹³⁵

iii. Other Fees

Credit card products include a long list of additional fees. Risk-related fees include late fees, overlimit fees, and bounced-check fees. Convenience and service fees include annual fees, cash-advance fees, stop-payment-request fees, fees for statement copies and replacement cards, foreign-currency-conversion fees, phone-payment-convenience fees, wire-transfer fees, and balance-transfer fees.¹³⁶ Many consumers

considering a change to its Truth-in-Lending rules that would generally prohibit rate increases unless the cardholder receives 45 days [sic] prior notice. The notice would allow the consumer to avoid the rate increase by paying off the card balance [at the pre-increase rate] or moving it to another card.

Rate Changes, CARDFLASH, September 28, 2007, available at <http://www.cardweb.com/cardflash/2007/09/28/rate-changes> (citing John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency, Remarks Before the Financial Services Roundtable (Sept. 27, 2007), available at <http://www.occ.gov/ftp/release/2007-104a.pdf>).

¹³³ *Rate Changes*, *supra* note 132.

¹³⁴ Issuers justify “universal default” as a component of efficient, risk-based pricing. It is not clear whether all the events that trigger “universal default” are indeed predictive of future nonpayment. Our point, however, is different: even if “universal default” is efficient ex post, meaning it efficiently increases prices only for high-risk borrowers, ex ante efficiency is sacrificed when borrowers underestimate the expected costs of the clause.

¹³⁵ Another recent innovation also magnifies the cost of penalty fees. Some issuers are dividing up credit extensions between multiple cards so that a customer with a \$2,500 credit limit will be issued five cards with five \$500 limits (instead of a single card with a \$2,500 limit). Five cards mean five opportunities to pay late fees, overlimit fees, etc. See generally Robert Berner, *Cap One’s Credit Trap*, BUS. WK., Nov. 6, 2006, at 35 (detailing Capital One’s practice of issuing several cards to its customers—even those customers who have currently outstanding overlimit balances—in order to generate more late fees and overage charges).

¹³⁶ See Mark Furletti, *Credit Card Pricing Developments and Their Disclosure* 10-13 (Fed. Reserve Bank of Phila., Payment Cards Center, Discussion Paper, 2003), available at http://www.philadelphiafed.org/pcc/papers/2003/CreditCardPricing_012003.pdf (detailing credit card fees).

are not aware of these fees—their existence, their magnitude, or the likelihood that they will be triggered—when signing up for a new credit card. The FRB's Regulation Z, which implements Truth in Lending Act (TILA) credit card disclosure requirements, does not require advance disclosure of all fees upon application or solicitation. Moreover, some of the existing fees are not specifically mentioned in Regulation Z and, as a result, issuers make their own decisions about disclosures.¹³⁷

On November 8, 2006 the U.S. District Court for the Southern District of New York approved a class-action settlement, by which Visa and MasterCard agreed to pay \$336 million to credit card and debit card holders for allegedly unlawful currency-conversion practices. (Visa and MasterCard deny any wrongdoing.) The class-action suit claimed, among other things, that issuers charged currency-conversion fees that were not appropriately disclosed, violating the provisions of TILA and the Electronic Funds Transfer Act.¹³⁸

When consumer behavior is not sensitive to a certain price dimension, issuers can be expected to increase this price dimension. Moreover, as the currency-conversion litigation suggests, issuers may be deliberately fostering misperception about certain price dimensions.

iv. Introductory Rates

The introductory teaser rate is another example of product design that targets consumers' imperfect rationality. Assuming that the costs of switching from one credit card to another are small, teaser rates would not be offered by an issuer that faces perfectly rational consumers. These consumers would transfer their balance to a new card with a low teaser rate as soon as the old card reverted to the high postintroductory rate.

¹³⁷ See *id.* at 13-14 ("Issuers generally disclose [phone-payment, wire-transfer and stop-payment] fees to consumers by including a menu or a description of these other fees in 'welcome kit' mailings to new customers or in 'Cardmember Agreements.'").

¹³⁸ See *In re Currency Conversion Fee Antitrust Litig.*, MDL No. 1409, slip op. at 3-4 (S.D.N.Y. July 8, 2006) (order granting preliminary approval of the settlement agreement), available at <http://www.ccfsettlement.com/documents/>; Third Consolidated Amended Class Action Complaint at 1, *In re Currency Conversion Fee Antitrust Litig.*, MDL No. 1409 (S.D.N.Y.), available at <http://www.ccfsettlement.com/documents/>; see also Furletti, *supra* note 136, at 14 ("Regulation Z does not explicitly address disclosure of the foreign currency conversion fee. Unlike most fees that can be observed upon a detailed review of a card statement, foreign currency conversion fees are often rolled into the transaction amount or the conversion factor.").

Issuers offer teaser rates because they are attractive to consumers who think they will switch, or pay off their balance, when the introductory period ends, but end up staying and paying the high postintroductory rates. There are two parts to this story. The first part focuses on the ex post stage. Ex post, consumers do not switch and borrow at the high postintroductory rates. In fact, a recent study found that most borrowing is done at the high postintroductory rates, rather than at the low teaser rates.¹³⁹ Another recent study estimated that effective switching costs must be approximately \$150 to explain the limited switching observed.¹⁴⁰ There is clearly a psychological-inertia component reflected in such high switching costs.

The second part of the story focuses on the ex ante stage. Not only do consumers fail to switch ex post, but they also fail to anticipate this effective lock-in ex ante. Alternatively, consumers simply believe that they will not need to borrow beyond the introductory period. The ex ante part of the story is necessary to explain why consumers are more sensitive to introductory rates than they are to long-term rates, despite the fact that most of the borrowing is done at the high long-term rates.¹⁴¹ In fact, a recent study found that “consumers are at least three times as responsive to changes in the introductory interest rate as compared to dollar-equivalent changes in the post-introductory interest rate”¹⁴² And survey evidence suggests that more than a third of all consumers consider an attractive introductory interest rate to be the prime selection criterion in credit card choice.¹⁴³

¹³⁹ See Gross & Souleles, *supra* note 77, at 171, 179. See also Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 263 (1997) (“[A] substantial portion of credit card borrowing still occurs at postintroductory interest rates[;] . . . finance charges paid to credit card issuers have not dropped as much as the introductory offers might suggest.”); David Laibson et al., *A Debt Puzzle*, in KNOWLEDGE, INFORMATION, AND EXPECTATIONS IN MODERN MACROECONOMICS 228, 228-29 (Philippe Aghion et al. eds., 2003) (finding that consumers pay high effective interest rates “[d]espite the rise of teaser interest rates”).

¹⁴⁰ Shui & Ausubel, *supra* note 73, at 24.

¹⁴¹ See Bar-Gill, *supra* note 15, at 1405-07 (explaining that “a consumer with a current financing need will take the teaser rate bait” because she underestimates her future borrowing).

¹⁴² Lawrence M. Ausubel, *Adverse Selection in the Credit Card Market* 21 (June 17, 1999) (unpublished manuscript), available at <http://www.ausubel.com/creditcard-papers/adverse.pdf>.

¹⁴³ EVANS & SCHMALENSEE, *supra* note 119, at 225.

v. Additional Design Features

Other features of the credit card contract are also designed to exploit consumers' imperfect information and imperfect rationality. In particular, many technical features of the credit card contract provide benefits to issuers while imposing underappreciated costs on consumers. Among these features are low (and even negative) amortization rates,¹⁴⁴ compounded interest,¹⁴⁵ pro-issuer payment allocation methods,¹⁴⁶ and balance-computation methods.¹⁴⁷ Issuers also commonly insert an arbitration clause that requires consumers to settle disputes by binding arbitration that excludes aggregation via class arbitration, blocks public access to information revealed in the arbitration, and eliminates the procedural rights that would have been available in the court system.¹⁴⁸

¹⁴⁴ Bar-Gill, *supra* note 15, at 1408. Recently, minimum payments have been going up, arguably in response to concerns voiced by consumer groups and the Federal Banking Agencies. See Press Release, Office of the Comptroller of the Currency, Comptroller Dugan Expresses Concern about Negative Amortization (Dec. 1, 2005), *available at* <http://www.occ.treas.gov/toolkit/newsrelease.aspx?Doc=I51QIBS3.xml> (noting new regulatory requirements for increased minimum credit card payments to avoid negative amortization); Letter from Richard Spillenkothen, Dir., Bd. of Governors of the Fed. Reserve Sys., to the Officer in Charge of Supervision and Appropriate Supervisory and Examination Staff at Each Federal Reserve Bank and to Banking Organizations Supervised by the Federal Reserve (Jan. 8, 2003), *available at* <http://www.federalreserve.gov/boarddocs/srletters/2003/sr0301.htm>. A recent amendment to TILA also improves the information that consumers receive on the costs of slow repayment. See The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 § 1301, 119 Stat. 23 (mandating the provision of examples of repayment timeframes using minimum payments).

¹⁴⁵ See Furletti, *supra* note 136, at 15 ("By adding finance charges to the balance each day, issuers increased finance charge revenue without increasing stated annual percentage rates.").

¹⁴⁶ See GAO, INCREASED COMPLEXITY REPORT, *supra* note 18, at 27 ("[C]ardholder payments [are often] allocated first to the balance that is assessed the lowest rate of interest."); Furletti, *supra* note 136, at 15 (discussing issuers' allocation of payments first to low APR balances).

¹⁴⁷ See GAO, INCREASED COMPLEXITY REPORT, *supra* note 18, at 27-28 (describing the two-cycle billing method); Furletti, *supra* note 136, at 16 (noting the effective elimination of the grace period through double-cycle interest).

¹⁴⁸ See 2005 Credit Card Survey, *supra* note 121, at 2 (detailing survey results revealing that more than 50% of banks use arbitration clauses).

b. *Mortgage Loans*

i. Deferred Costs

Some mortgage products, like credit cards, defer much of the product's cost into the future (beyond what is inherently implied by a loan contract). Specifically, subprime mortgage contracts often require a very small, or even zero, down payment.¹⁴⁹ In addition, the common 2/28 (or 3/27) hybrid mortgages offer low introductory interest rates for the initial two (or three) year period, to be followed by sharp increases in payments.¹⁵⁰ These features of the mortgage product may be responding to consumers' optimism bias. A consumer who overestimates the rate by which her income will increase will prefer a mortgage with a small down payment and a low introductory rate.¹⁵¹ When the introductory period ends and her income does not increase as expected, this consumer may face foreclosure.

In addition, when taking loans, consumers can overestimate the availability and attractiveness of refinancing options at the end of the introductory period. Consumers may also underestimate the deterrent effect of the prepayment penalty, a charge that is often many thousands of dollars and makes refinancing very expensive. Consumers who misestimate the costs or availability of refinancing, will necessarily underestimate the likelihood of paying the high postintroductory rate. Moreover, consumers might overestimate their ability to make optimal refinancing decisions. The complexity of the optimal refinancing decision, and the evidence that many consumers fail to make optimal refinancing decisions, suggest that mortgage products that appear attractive largely because of the refinancing option may be responding to consumers' imperfect rationality. This hypothesis is especially powerful given the market's rejection of alternative product designs that are less demanding of the consumer.¹⁵² Arguably, the

¹⁴⁹ Bar-Gill, *supra* note 96 (manuscript at 15-16).

¹⁵⁰ *Id.*

¹⁵¹ *Id.*; see also Willis, *supra* note 90, at 778 (invoking consumer myopia as an explanation for introductory rates).

¹⁵² See Campbell, *supra* note 6, at 1585-86 (arguing that the common contractual designs "reward sophisticated decision making and continuous monitoring of financial markets," and suggesting that such contractual designs, rather than less-demanding designs proposed by economists—for example, mortgages that adjust interest and principal payments for inflation, and automatically refinancing nominal FRMs—may be responding to consumers' imperfect rationality).

business model based on low teaser rates is viable only because many consumers refinance less often than they anticipate.¹⁵³

ii. Proliferation of Fees

Comparison shopping for cars is relatively easy because the customer can compare total prices for similar products. Mortgage borrowing is much more complex because lenders have disaggregated fees. The cost of borrowing money now includes a number of fees, such as origination fees (including document-preparation fees, underwriting-analysis fees, tax-escrow fees, and escrow-fund-analysis fees) that are often not disclosed until late in the purchasing process. It is as if a person purchasing a car discovered only at the time of sale that there would be additional charges for paint, for a bumper, and for tires. Such additional charges would likely be omitted from the buyer's initial estimates of affordability and would escape inclusion as the buyer compared different loan options.¹⁵⁴

Similarly, costs imposed later or not at all, such as late fees, foreclosure fees, and prepayment penalties, are likely to be omitted from a buyer's analysis. These fees can be 10% (and sometimes more) of the loan value.¹⁵⁵ Such fees, including those imposed at origination, at refinancing, and at default, have proliferated, presumably as lenders have seen them as an opportunity to increase revenues without en-

¹⁵³ Such an outcome can be explained either by an underestimation of refinancing costs or by an underestimation of the difficulty of making optimal refinancing decisions. See DAVID MILES, *THE UK MORTGAGE MARKET: TAKING A LONGER-TERM VIEW, INTERIM REPORT: INFORMATION, INCENTIVES, AND PRICING* § 3 (2003)) (concluding, based on an analysis of the UK mortgage market, that lenders can offer attractive teaser rates only because many consumers fail to refinance); see also DAVID MILES, *THE UK MORTGAGE MARKET: TAKING A LONGER-TERM VIEW: FINAL REPORT AND RECOMMENDATIONS* 97 (2004) (noting borrowers' poor understanding of interest-rate risks).

¹⁵⁴ To many consumers, the single most salient feature of the loan is the monthly payment. Lenders will therefore manipulate their product design to present a low monthly payment. The monthly payment, however, is a poor proxy for the true price of the loan, given the complexity and multidimensionality of subprime mortgage loans. See Bar-Gill, *supra* note 96 (manuscript at 19-20) (detailing the sources of origination fees such as credit checks, certifications, and document preparation); Willis, *supra* note 90, at 780-89 (deveopling the argument that "borrowers who rely on monthly payments as a simplifying heuristic are vulnerable to price gouging").

¹⁵⁵ See Willis, *supra* note 90, at 731 (highlighting a reduction in origination fees to 10% from 25%).

countering customer resistance.¹⁵⁶ These products are arguably designed to maximize profits from consumer decision-making errors.

The numerous fees and penalties together with adjustable interest rates have transformed the mortgage loan into a product with multidimensional, nontransparent pricing. Multidimensionality enables tailoring of the product to the special needs of each borrower. But it also creates information problems that sharply inhibit comparison shopping.¹⁵⁷

c. *Payday Loans*

Perhaps the most dangerous feature of the payday-loan product is the loan rollover. Many payday borrowers do not pay back the loan on the next payday. Instead, they roll over, meaning they renew the loan for another period. A Federal Deposit Insurance Corporation (FDIC) study by Mark Flannery and Katherine Samolyk found that about 46% of all payday loans are either renewals of existing loans or new loans that follow immediately upon the payment of an existing loan.¹⁵⁸ Other studies have found even higher rollover rates. A study by the DoD found that among U.S. military personnel “75% of payday customers are unable to repay their loan within two weeks and are forced to get a loan ‘rollover’ at additional cost.”¹⁵⁹ And a study by the Center for Responsible Lending found that 90% of payday loans are made to borrowers with five or more payday loans per year.¹⁶⁰

The design of the payday loan as a short-term cash advance that is oftentimes continuously renewed for prolonged periods of time responds to consumers’ underestimation of the likelihood and cost of loan rollover. Researchers at the Center for Responsible Lending observe that “[s]ince the loan comes due on payday, borrowers expect to have money in their account to cover the check. Many borrowers, however, find that paying back the entire loan on payday would leave them without funds necessary to meet basic living expenses, such as

¹⁵⁶ *Id.* at 725, 731, 766-68; see also Bar-Gill, *supra* note 96 (manuscript at 30-31) (“[I]ncreased complexity . . . allows [lenders] to hide the true cost of the loan in a multidimensional pricing maze.”).

¹⁵⁷ Willis, *supra* note 90, at 726-28; Bar-Gill, *supra* note 96; see also McCoy, *supra* note 99, at 124 (finding that subprime price quotes are available only after payment of nonrefundable fees).

¹⁵⁸ Flannery & Samolyk, *supra* note 113.

¹⁵⁹ DOD, REPORT ON PREDATORY LENDING, *supra* note 3, at 14.

¹⁶⁰ See *supra* note 113 and accompanying text (discussing rollover costs).

electricity, rent, and groceries.”¹⁶¹ This results in an unanticipated rollover, which means the cost of the loan is far higher than the consumer initially assessed. The payday loan product is arguably designed to take advantage of consumers’ optimism bias and their consistent underestimation of the risk of nonpayment.

C. *The Harm: Implications of Credit Market Failure*

1. Harm to Consumers

The evidence summarized above suggests that many credit products are extremely costly to consumers. The data on credit card choice and use show that consumer mistakes cost hundreds of dollars a year per consumer. Failure to switch cards at the end of the introductory period costs \$250 a year.¹⁶² Choosing lower introductory rates lasting for shorter introductory periods instead of higher introductory rates lasting for longer introductory periods costs \$50 a year.¹⁶³ Paying high interest rates on credit card balances while holding liquid assets that yield low returns costs \$200 a year.¹⁶⁴ Consumer mistakes in choosing mortgage products cost even more. Borrowers who take a \$100,000 thirty-year subprime loan while qualifying for a comparable prime loan suffer an average financial harm of over \$200 per month, \$2400 per year, and over \$70,000 in total.¹⁶⁵ More generally, mistakes that prevent effective competition within the subprime market cost borrowers an average of \$3370 a year.¹⁶⁶ Suboptimal prepayment decisions alone can cost borrowers tens of thousands of dollars or up to 25% of the loan’s value.¹⁶⁷ In the payday loan market, a 2004 study by the Center for Responsible Lending estimated that, each year, predatory payday lending practices cost U.S. families \$3.4 billion in excess

¹⁶¹ ERNST FARRIS & KING, *supra* note 113, at 3; *see also* Mann & Hawkins, *supra* note 111, at 882 (“[T]here is every reason to think that typical decision-making problems like the availability heuristic and the optimism bias cause the typical consumer to give inadequate weight to the risk that the [payday] transaction will turn out poorly.”).

¹⁶² *See supra* note 73 and accompanying text.

¹⁶³ Shui & Ausubel, *supra* note 73, at 8-9.

¹⁶⁴ *See supra* note 77 and accompanying text.

¹⁶⁵ *See supra* note 98 and accompanying text.

¹⁶⁶ *See supra* note 101 and accompanying text.

¹⁶⁷ *See supra* note 110 and accompanying text.

fees and charges.¹⁶⁸ And a DoD study reported a cost of \$80 million every year to military families from abusive payday-loan fees.¹⁶⁹

These numbers suggest that harm to consumers is substantial. The aggregate costs are staggering. The per-consumer costs must be multiplied by the large numbers of consumers who bear these costs. The \$250 cost of failing to switch cards at the end of the introductory period is born by 35% of borrowing consumers who chose cards with introductory offers—1.4 million consumers each year.¹⁷⁰ This implies an aggregate annual cost of \$350 million. And this for a single mistake triggered by a single design feature of the credit card product. In the home-mortgage market, 35% of prime-qualified borrowers,¹⁷¹ or 480,000 borrowers,¹⁷² get a subprime loan and pay an extra \$2,400 a

¹⁶⁸ ERNST, FARRIS & KING, *supra* note 113, at 2. Average APRs for payday loans range from 391% to 443% in conservative estimates. “This estimate is conservative because it does not account for additional costs related to insufficient fund (NSF) fees, bounced check fees, disparities between the credit risk and effective interest rate charged borrowers, and increased public costs due to collection efforts and payday lending induced bankruptcies.” *Id.* at 2 n.1. A DoD study has found that APRs for payday lending have reached as high as 780%. DOD, REPORT ON PREDATORY LENDING, *supra* note 3, at 10.

¹⁶⁹ DOD, REPORT ON PREDATORY LENDING, *supra* note 3, at 12.

¹⁷⁰ This number is based on the following data: (1) about 17 million households open a new general purpose credit card account each year; (2) about 50% of new accounts include introductory rates; (3) about 50% of cardholders carry a balance. *See Fixed Rate vs Intro Rate*, CARDFLASH, July 29, 1999 (reporting findings from a 1999 study of account acquisition and attrition conducted by PSI Global); Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, 89 FED. RES. BULL. 1, 23-25 (2003) (stating that, according to 2001 SCF data, 44.4% of households carry credit card debt; among the 72.7% of households holding at least one bank card, 53.7% carry a balance); David I. Laibson et al., *supra* note 139 230, 231 (noting that the fraction of households with at least one credit card that are borrowing on their credit cards is 63%). We recognize that cards with introductory offers might be issued at different rates to borrowing and nonborrowing consumers or households. Nevertheless, the preceding calculation probably yields a conservative estimate, if issuers are more likely to target introductory offers to borrowers and/or if borrowers are more likely to be attracted by introductory offers.

¹⁷¹ Carr & Kolluri, *supra* note 90, at 37; *cf.* Sichelman, *supra* note 89, at 25 (claiming that up to 40% of Citi customers received loans at higher rates than they qualified for); Willis, *supra* note 90, at 730 (“It is estimated that as many as half of the borrowers with subprime loans were qualified for lower prime interest rate loans . . .”).

¹⁷² The 480,000 figure was calculated by multiplying the percentage of subprime borrowers who could have qualified for more conventional prime loans (20%) by the total number of subprime borrowers (2.4 million). *See* STEIN, *supra* note 101, at 14 n.49 (providing the 2.4 million figure); Mike Hudson & E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck with Higher-Rate Loans*, L.A. TIMES, Oct. 24, 2007, at A1 (providing the 20% figure).

year, on average.¹⁷³ This implies an aggregate annual cost of approximately \$1.3 billion. More generally, imperfect competition and consumer mistakes in the subprime mortgage market cost 2.4 million borrowers a total of \$9.1 billion annually.¹⁷⁴ And yet these numbers underestimate the full magnitude of the harm caused by unsafe credit products. The data measure only the bluntest errors. The costs imposed by dozens of other potential mistakes, particularly those associated with complex pricing, remain unmeasured. More importantly, these numbers do not include the cost of financial distress.¹⁷⁵

While the per-accident harm caused by unsafe physical products may exceed the “per-accident” harm caused by unsafe credit products, the number of victims of financial products is much larger.¹⁷⁶ Tens of millions of consumers pay more than they should on their credit cards, mortgages, or payday loans. By comparison, only 80,000 consumers are harmed in lawnmower-related accidents each year.¹⁷⁷ For present purposes, the important point is that aggregate harm from unsafe credit products is sufficiently large to justify a systematic examination of possible regulatory fixes. Of course, unlike harm caused by physical products, harm caused by financial products is not a direct welfare cost, but rather it is a transfer from consumers to sellers of credit. Yet, when this transfer is the product of mistake, a welfare cost will often follow. We further elaborate on these welfare costs below.

2. Externalities

Consumer mistakes, especially when coupled with product design aimed at exploiting these mistakes, hurt consumers. The welfare costs of these mistakes are not limited to the direct harm suffered by the

¹⁷³ See Willis, *supra* note 90, at 729.

¹⁷⁴ STEIN, *supra* note 101, at 2-3, 18-19.

¹⁷⁵ Recent evidence shows a causal link between unsafe credit products and financial distress, including bankruptcy. See MANN, *supra* note 3, ch. 3 (arguing that a rise in credit card use is causally connected to increased rates in bankruptcy filings).

¹⁷⁶ Cf. Letter from Comm’rs of the FTC to Wendell H. Ford, Chairman of the Consumer Subcomm. of the House Comm. on Commerce, Sci., and Transp., and John C. Danforth, Ranking Minority Member of the Consumer Subcomm. 6 n.12 (Dec. 17, 1980), available at <http://www.ftc.gov/bcp/policystmt/ad-unfair.htm> (describing consumer injury as potentially “substantial if it does a small harm to a large number of people, or if it . . . raises a significant risk of concrete harm”).

¹⁷⁷ *A Little Safety Goes a Long Way with DIY* (NPR radio broadcast June 21, 2007), available at <http://www.npr.org/templates/story/story.php?storyId=11220621>.

mistaken consumers. Unsafe credit products generate a series of negative externalities.¹⁷⁸

a. *The Cost of Financial Distress*

The costs of financial distress are borne by immediate family members. For example, the 1.8 million people filing bankruptcy in 2001 were matched by another 1.9 million children and elderly adult dependents who were not directly responsible for the bills, but who lived in households that declared bankruptcy.¹⁷⁹ Indeed, households with children are nearly three times more likely to declare bankruptcy than their childless counterparts.¹⁸⁰

The negative effects of economic distress on children have not been studied extensively, but research hints at the future these children face. The catalog of damages inflicted on children when their parents divorce—falling test scores, low self-esteem, discipline problems, depression—also applies to middle-class children whose parents are in financial trouble.¹⁸¹ Financial collapse has an additional wrinkle less common among children of divorce: it often sends a child

¹⁷⁸ See Mann & Hawkins, *supra* note 111, at 881-84 (discussing how financial distress resulting from debt generally increases the overall burden on the social safety net, including effects upon health, employment, and family, and how payday lending, specifically, decreases competition, choice, and overall welfare of relevant neighborhoods); see also JEC REPORT, *supra* note 3, at 13-18, 37-41 (warning of myriad negative pressures resulting from rampant foreclosures on subprime mortgages, including: depressed neighboring housing prices; foreclosure costs falling on homeowners, taxpayers, local governments, and mortgage servicers; lost tax revenues from abandoned homes; creation of tax liabilities for homeowners; tightening of lending standards for families facing foreclosures; a contagion effect whereby concentrated foreclosures cause additional foreclosures; and higher levels of violent crime).

¹⁷⁹ Elizabeth Warren, *Bankrupt Children*, 86 MINN. L. REV. 1003, 1010 fig.1 (2002).

¹⁸⁰ *Id.* at 1013 fig.3. For two-parent households the ratio of bankruptcies for families with minor children and those with no minor children is about 2:1, and for single-parent households the ratio is about 4:1. *Id.* at 1015 fig.4.

¹⁸¹ See SUSAN E. MAYER, WHAT MONEY CAN'T BUY: FAMILY INCOME AND CHILDREN'S LIFE CHANCES 76-77 (1997) (finding that five- to seven-year-olds whose parents experienced a drop in income of 35% or more between two adjacent years were more likely to experience lower test scores and behavior problems in the classroom). Mayer controlled for other factors, such as parents' marital status, race, and parents' age at the birth of the child. *Id.* at 77 tbl.4.5; see also Dania S. Clark-Lempers et al., *Family Financial Stress, Parental Support, and Young Adolescents' Academic Achievement and Depressive Symptoms*, 10 J. EARLY ADOLESCENCE 21, 33 (1990) (reporting that adolescents from families in financial distress are more likely to experience depression); Les B. Whitbeck et al., *Family Economic Hardship, Parental Support, and Adolescent Self-Esteem*, 54 SOC. PSYCHOL. Q. 353, 353-54 (1991) (finding that adolescents from families in financial distress are more likely to experience low self-esteem).

into adult roles long before her time. Sociologist Katherine Newman observes that “[f]or downwardly mobile families, it is the parents who need their kids’ emotional support. . . . Their children want to be more independent, but a sense of responsibility and obligation pulls them back.”¹⁸²

For elderly relatives relying on adult children who get into financial trouble, the impact may be immediate. An estimated 20,000 households filing for bankruptcy in 2001 indicated they had to move an elderly relative to a cheaper care facility in order to deal with their financial problems.¹⁸³ Financial distress can impose significant costs on ex-spouses or noncustodial children if the debtor is no longer able to pay support. Women’s groups across the country uniformly opposed amendments to the bankruptcy laws in part because of their concern that ex-husbands would be under so much pressure from credit card issuers and mortgage lenders that there would be nothing left for support recipients.¹⁸⁴ Not even death will insulate families from the sting of aggressive debt collectors. Sears, for example, had a special team to collect from bereaved families when a customer died still owing a credit balance—even though the family had no legal obligation to pay these debts.¹⁸⁵

Bankruptcy may be the extreme measure of financial distress, but not all families in financial trouble declare bankruptcy. A survey of households in 2007 showed that 40% of families were “very concerned” or “somewhat concerned” about paying their bills that month.¹⁸⁶ Nearly half of all credit card holders missed at least one

¹⁸² KATHERINE S. NEWMAN, *FALLING FROM GRACE: DOWNWARD MOBILITY IN THE AGE OF AFFLUENCE* 105 (1999).

¹⁸³ *Bankruptcy Reform: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 25 (Feb. 10, 2005) (statement of Elizabeth Warren), available at http://judiciary.senate.gov/testimony.cfm?id=1381&wit_id=3996 (presenting unpublished data from the 2001 Consumer Bankruptcy Project).

¹⁸⁴ See, e.g., JOAN ENTMACHER, NAT’L WOMEN’S LAW CTR., *BANKRUPTCY BILL WILL HARM ECONOMICALLY VULNERABLE WOMEN AND THEIR FAMILIES* 1-2 (2002) (arguing that proposed bankruptcy reform would make the collection of child support more difficult); Elizabeth Warren, *What is a Women’s Issue? Bankruptcy, Commercial Law and Other Gender-Neutral Topics*, 25 HARV. WOMEN’S L.J. 19, 21 (2002) (noting that no women’s group has publicly endorsed proposed restrictions on bankruptcy).

¹⁸⁵ WARREN & WARREN TYAGI, *supra* note 98, at 142-43.

¹⁸⁶ Press Release, Consumer Fed’n of Am., *Holiday Spending Plans: More Consumers Than in Previous Years Say They Will Cut Spending* (Nov. 19, 2007), available at http://www.consumerfed.org/pdfs/Holiday_Spending_Press_Release_11-19-07.pdf.

payment last year,¹⁸⁷ and an additional 2.1 million families missed one or more mortgage payments.¹⁸⁸ In 2004, about one in every six households in the U.S. dealt with a debt collector.¹⁸⁹ Economist Michelle White has estimated that about 17% of *all* households in the United States would see a significant improvement in their balance sheets if only they were willing to sign a bankruptcy petition.¹⁹⁰ That is, 18 million households would have profited from a bankruptcy filing, compared with the 1.5 million that actually filed, suggesting that at least 16.5 million families who did not file for bankruptcy are dealing with some form of financial distress—and some of its attendant costs.¹⁹¹

The impact of financial distress does not stop with the immediate family. An individual in financial distress will often require support from more distant family, friends, or the state. Such transfers from one individual to another, including transfers mediated by the state, involve transaction costs. These transaction costs are especially large when the bankruptcy system—and the attendant lawyers' fees, filing fees, claim forms, and other paperwork—is involved.

Foreclosures can be even more expensive. Bank takeovers of residential housing cost taxpayers money and threaten the economic stability of already-imperiled neighborhoods.¹⁹² A recent housing report

¹⁸⁷ Walecia Konrad, *How Americans Really Feel About Credit Card Debt*, BANKRATE.COM, Feb. 20, 2007, at 3, http://www.bankrate.com/brm/news/financial_literacy/Feb07_credit_card_poll_national_a1.asp (follow "3" hyperlink beneath article title).

¹⁸⁸ Sandra Block, *Foreclosure Hurts Long after Home's Gone, So Cut a Deal While You Can*, USA TODAY, Mar. 23, 2007, at 3B.

¹⁸⁹ TOM W. SMITH, TROUBLES IN AMERICA: A STUDY OF NEGATIVE LIFE EVENTS ACROSS TIME AND SUB-GROUPS 23 tbl.2 (2005) (noting that 15.8% of Americans dealt with payment pressure from stores, creditors, or bill collectors in 2004); Lucy Lazarony, *Denying Our Debt*, BANKRATE.COM, Apr. 6, 2004, <http://www.bankrate.com/brm/news/financial-literacy2004/debt-denial.asp> (observing that 11% of Americans have had a credit card bill go to collection).

¹⁹⁰ Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685, 718 tbl.2 (1998). White shows that about 17% of U.S. households would profit from filing for bankruptcy—and yet, for some reason, presumably at least somewhat influenced by a sense of shame or stigma, they do not file. *Id.*

¹⁹¹ See U.S. Census Bureau, Table AVG1: Average Number of People per Household, by Race and Hispanic Origin, Marital Status, Age, and Education of Householder: 2007, *available at* <http://www.census.gov/population/socdemo/hh-fam/cps2007/tabAVG1.xls> (providing the total number of American households, 116,011,000).

¹⁹² See JEC REPORT, *supra* note 3, at 15-16; see also Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, N.Y. TIMES, Sept. 2, 2007, at § 3; Henry M. Paulson, Jr., U.S. Sec'y of the Treasury, Remarks on Current Housing and Mortgage Market Developments (Oct. 16, 2007), *available at* <http://www.treasury.gov/press/releases/>

observed: “Foreclosures are costly—not only to homeowners, but also to a wide variety of stakeholders, including mortgage servicers, local governments and neighboring homeowners. . . . [Costs can reach] up to \$80,000 for all stakeholders combined”¹⁹³ Lenders can lose as well, forfeiting as much as \$50,000 per foreclosure, translating into roughly \$25 billion in total foreclosure-related losses in 2003.¹⁹⁴ “[A] city can lose up to [\$19,227] per house abandoned in foreclosure in lost property taxes, unpaid utility bills, property upkeep, sewage and maintenance.”¹⁹⁵ Many foreclosure-related costs fall on taxpayers who ultimately pay the bill for services provided by their local governments.

Financial distress also affects the productivity of borrowers-workers. Recent evidence collected by the DoD shows that employees or, in the DoD’s case, military personnel, become less productive when in financial distress.¹⁹⁶ This finding should not come as a surprise. An employee concerned about debt repayment and about protecting her family from abusive debt-collection practices is clearly less able to focus on work.¹⁹⁷

b. *Market Distortions*

Consumer mistakes also lead to market distortions, preventing markets from attaining allocative efficiency. Consumer mistakes skew the demand function, inflating demand for products with underesti-

hp612.htm (“Foreclosures are costly and painful for homeowners. They are also costly for mortgage servicers and investors. They can have spillover effects into property values throughout a neighborhood, creating a downward cycle we must work to avoid.”).

¹⁹³ JEC REPORT, *supra* note 3, at 17. See also Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL’Y DEBATE 57, 69, 70-72 (2006) (finding that a single-family home foreclosure causes a decrease in values of homes within an eighth of a mile—or one city block—by an average of 0.9% to 1.136%, or approximately \$1,870 when the average home sale price is \$164,599, and 1.44% in low- and moderate-income communities, or about \$1,600 when the average home sale price is \$111,002).

¹⁹⁴ See, e.g., Desiree Hatcher, *Foreclosure Alternatives: A Case for Preserving Homeownership*, PROFITWISE NEWS AND VIEWS (Fed. Reserve Bank of Chi., Chi., Ill.), Feb. 2006, at 2, available at http://www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf (observing that five-hundred-thousand nonfarm mortgage loans were in foreclosure at the end of 2003, causing \$25 billion in costs for lenders).

¹⁹⁵ JEC REPORT, *supra* note 3, at 38.

¹⁹⁶ See DOD, REPORT ON PREDATORY LENDING, *supra* note 3, at 39-43 (listing case studies involving military personnel with loan troubles).

¹⁹⁷ The DoD report also describes how military personnel in financial distress become more vulnerable to extortion and, consequently, lose their security clearance. *Id.* at 35-36, 86-87.

mated risks. The inflated demand skews the market price and leads to allocative inefficiency.

Consider two credit products, a closed-end bank loan and a credit card. The bank loan is better suited for some consumers and for certain purposes. And the credit card is better suited for other consumers and for other purposes. Now assume that the credit card, by its nature or by specific design, triggers more consumer mistakes. And because of these mistakes, the relative attractiveness of the credit card increases. The result would be that consumers, who, absent mistakes and misperception, would take a closed-end bank loan, opt for credit card financing instead. The increased demand for credit cards and the reduced demand for bank loans affect the relative prices of these two credit products. As a result, mistakes by imperfectly informed and imperfectly rational consumers distort the financing choices of informed, rational consumers as well.¹⁹⁸

Similarly, with imperfect information and imperfect rationality, credit may seem less costly than it really is. Accordingly, more consumers will want to borrow. The economy will respond by shifting resources to meet this increased demand—a shift that, given the mistakes underlying the increased demand, leads to allocative inefficiency (since there are better uses for these resources). The most recent example is in the subprime mortgage industry. Artificially inflated demand for financing, fueled in part by consumer mistakes, contributed to the real-estate bubble.

Another market distortion is caused when an increased risk of default caused by unsafe products increases the prices of safe products. A consumer who gets into financial trouble is likely to default on most or all outstanding credit obligations, not just on those that caused the problem. When a debtor is out of money, the losses are often shared by “good” creditors and “bad” creditors alike. Because unsafe credit products increase the risk of default on all credit obligations, costs increase both for safe and for unsafe credit products. Anticipating an increased likelihood of nonpayment, sellers of safe products are forced to increase the price of their products, pricing in the risk of default caused by the unsafe products. The higher prices that consum-

¹⁹⁸ See Bar-Gill, *supra* note 15, at 1434 (“[S]ellers will not compete on dimensions of the product . . . that are invisible to imperfectly rational consumers.”).

ers must pay for safe products represent another cost of unsafe products.¹⁹⁹

3. Distributional Concerns

The preceding subsections described how unsafe credit products reduce the overall amount of resources in a society. Unsafe credit products also regressively redistribute the remaining resources.

There are several reasons for this distributional effect: First, not all consumers have identical information, and not all are equally rational. Better-educated consumers are less likely to make mistakes. Richer consumers are also less likely to make mistakes, if only because they can hire experts who will prevent them from making mistakes.²⁰⁰ Second, as a consequence of these differences in information and rationality, sellers targeting less-educated, poorer consumers will offer more products that are finely tuned to exploit consumer mistakes. Third, if poor consumers are generally in greater need of financing than rich consumers, then poor consumers will suffer more from mistakes related to the choice and use of consumer credit products. Finally, if richer consumers make a credit mistake, they can often buy their way out of the problem—paying off a credit card bill in full or refinancing a mortgage on more favorable terms. Poor consumers lack the financial cushion that rich consumers have, and therefore they are more vulnerable to the unexpected costs of credit products and are more likely to stumble into financial distress. In his American Finance Association 2006 Presidential Address, John Campbell showed that “for a minority of households, particularly poorer and less educated households, there are larger discrepancies [between observed and ideal behavior] with potentially serious consequences.”²⁰¹ Campbell speculates that “the existence of naive households [i.e., the

¹⁹⁹ Perhaps even more costly, from a social welfare perspective, are the ex ante distortions caused by the prospect of financial distress. A lender will have an added incentive to offer an unsafe credit product if it can recover not only from the borrower but also from the borrower's family, friends, and perhaps also from the state (via welfare payments made to the borrower) when the borrower is in financial distress. Cf. Eric Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 318-19 (1995) (arguing that stricter usury laws can serve to counteract market distortions due to welfare programs).

²⁰⁰ See Lyons et al., *supra* note 66, at 25 (“[C]onsumers who were less educated, lower-income, older, or Hispanic tended to be less knowledgeable [about credit reporting].”).

²⁰¹ Campbell, *supra* note 6, at 1554.

poorer and less educated households that make mistakes] permits an equilibrium . . . in which confusing financial products generate a cross-subsidy from naive to sophisticated households, and in which no [other] market participant has an incentive to eliminate this cross-subsidy.”²⁰²

Available evidence supports these observations about the disparate impact of consumer mistakes across different socioeconomic groups.²⁰³ Evidence suggests that better-educated, richer consumers make fewer mistakes in the home mortgage market. For example, Susan Woodward found that consumers with a college education avoid mistakes that cost less sophisticated consumers \$1500 on average in broker fees.²⁰⁴ In a more recent study, Woodward found that offers made by brokers to borrowers without a college education are \$1100 higher on average.²⁰⁵ Robert Van Order et al. found that “low-income [mortgage] borrowers are less likely to prepay when it is optimal for them to do so.”²⁰⁶ In the credit cards market, recent evidence shows that poorer consumers make more mistakes. Using a rich data set covering almost 90,000 individuals, Nadia Massoud, Anthony Saunders, and Barry Scholnick found that poorer consumers were more likely to incur unnecessary late fees and overlimit fees even when they had sufficient money in their deposit accounts so that they could have avoided these costs.²⁰⁷ The study accounted for the possibility that funds in deposit accounts are being held as precautionary balances.²⁰⁸

²⁰² *Id.* at 1555.

²⁰³ For example, Essene and Apgar state that

the recent rise in mortgage delinquencies and foreclosures suggests that some households are taking on debt that they have little or no capacity to repay . . . , [and/or] taking out mortgages that . . . are not suitable for their needs. . . . [T]he concentration of foreclosures in many of the nation’s lowest-income and economically vulnerable neighborhoods threatens to reverse recent gains in efforts to expand homeownership opportunities for all.

ESSENE & APGAR, *supra* note 94, at i; *see also* Willis, *supra* note 90, at 725-27 (explaining how creative loan structuring can help or hurt consumers depending on their sophistication).

²⁰⁴ Woodward, *supra* note 108, at 2.

²⁰⁵ WOODWARD, *supra* note 100, at ix, 49.

²⁰⁶ Van Order et al., *supra* note 109, at 21.

²⁰⁷ *See* Massoud, Saunders & Scholnick, *supra* note 88, at 33 (concluding that poorer individuals pay fees due to inattention and mistake rather than financial difficulty).

²⁰⁸ *See id.* at 14 (suggesting that “individuals with low cash flows may hold additional deposits as precautionary balances”).

There is also evidence of disparate impact across different racial groups.²⁰⁹ Studies have shown persistent disparities in the share of subprime lending made to African-American and Hispanic borrowers versus similarly situated whites.²¹⁰ A study by the Federal Reserve Board, evaluating 177,487 subprime loans, suggested the possibility that “minority borrowers are incurring prices on their loans that are higher than is warranted by their credit characteristics.”²¹¹ Another study, based on the Federal Reserve data, found that “African-American and Latino borrowers are at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors.”²¹² A third study by the Survey Research Center at the

²⁰⁹ See WILLIAM APGAR, AMAL BENDIMERAD & REN S. ESSENE, JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV., MORTGAGE MARKET CHANNELS AND FAIR LENDING: AN ANALYSIS OF HMDA DATA 1-2 (2007), available at http://www.jchs.harvard.edu/publications/finance/mm07-2_mortgage_market_channels.pdf (evaluating competing claims about the causes of observed differences in mortgage lending outcomes along racial lines); Massoud, Saunders & Scholnick, *supra* note 88, at 9 (describing the practice of “redlining,” where banks make mortgage decisions based on the racial composition of neighborhoods); Editorial, *Subprime in Black and White*, N.Y. TIMES, Oct. 17, 2007, at A26 (arguing that lawmakers must aggressively investigate the existence of racial discrimination by lenders).

²¹⁰ See BRADFORD CALVIN, CTR. FOR CMTY. CHANGE, RISK OR RACE? RACIAL DISPARITIES AND THE SUBPRIME REFINANCE MARKET 6-8 (2002), available at <http://butera-andrews.com/legislative-updates/directory/Background-Reports/Center%20for%20Community%20Change%20Report.pdf> (positing a direct relationship between disparities in subprime lending and income that exists throughout all regions and metropolitan areas of the United States); FISHBEIN & WOODALL, *supra* note 94, at 24 (showing the increased likelihood of African-American and Hispanic homeowners receiving payment option mortgages); U.S. DEP’T OF HOUS. & URBAN DEV. & U.S. DEP’T OF THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING 35 (2000), available at <http://www.huduser.org/publications/pdf/treasrpt.pdf> (noting that “black borrowers accounted for 19 percent of all subprime refinance loans but only 5 percent of overall refinance mortgages”); Paul Calem, Kevin Gillen & Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, 29 J. REAL EST. FIN. & ECON. 393, 401-404 (2004) (examining racial disparity in subprime lending in Philadelphia and Chicago, and finding the highest concentration of subprime loans among African-American homeowners).

²¹¹ Robert B. Avery, Glenn B. Canner & Robert E. Cook, *New Information Reported Under HMDA and Its Application in Fair Lending Enforcement*, 91 FED. RES. BULL. 344, 381, available at http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf. This study did not offer any firm conclusions regarding the illegal predatory targeting of protected classes, choosing instead to simply note that Home Mortgage Disclosure Act (HMDA) data alone are “insufficient to account fully for racial or ethnic differences in the incidence of higher-priced lending . . .” *Id.* at 379.

²¹² DEBBIE GRUENSTEIN BOCIAN ET AL., CTR. FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 3 (2006), available at http://www.responsiblelending.org/pdfs/rr011exec-Unfair_Lending-0506.pdf.

University of Michigan found that “black homeowners are significantly more likely to have prepayment penalties or balloon payments attached to their mortgages than non-black homeowners, even after controlling for age, income, gender, and creditworthiness.”²¹³ And a fourth study, by Susan Woodward, found that black borrowers pay an additional \$415 in mortgage fees and Latino borrowers pay an additional \$365 in mortgage fees.²¹⁴

In addition, consumer shopping behavior differs across racial groups. “African-Americans are more than 50 percent *less* likely than Hispanics and the general population to shop for an equity lender at their own bank, savings and loan or credit union,”²¹⁵ which generally offer more favorable rates. Furthermore, studies have shown that African-Americans “systematically underestimate their credit worthiness” and are less likely to apply for mortgage financing.²¹⁶ As a result, African-Americans as a group are “more likely to obtain a loan after being ‘sold a loan,’” which was crafted and targeted at them, “than as a result of having searched for a loan.”²¹⁷

A recent survey conducted by a Hispanic civil rights and advocacy group, the National Council of La Raza, found that 56% of Hispanic households use credit cards, and that nearly 77% of Hispanic credit card users carry a balance on their credit cards, compared to 45% of all credit card users.²¹⁸ Moreover, 19.3% of Hispanics describe their credit card debt situation as “burdensome and not enough money to pay down [the balance]” and 11.4% report that they are “maxed out and can’t use [their cards].”²¹⁹ One of the major problems, according to the National Council of La Raza, is that nearly 22% of Hispanic

²¹³ Michael S. Barr et al., *Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low- and Moderate-Income Neighborhoods* 2-3 (April 2008), available at <http://ssrn.com/abstract=1121215>.

²¹⁴ WOODWARD, *supra* note 100, at ix, 45-46.

²¹⁵ AARP, 2003 CONSUMER EXPERIENCE SURVEY: INSIGHTS ON CONSUMER CREDIT BEHAVIOR, FRAUD AND FINANCIAL PLANNING 41 (2003), available at http://assets.aarp.org/rgcenter/consume/cons_exp.pdf.

²¹⁶ ESSENE & APGAR, *supra* note 94, at 23; *see also* Campbell, *supra* note 6, at 1584 (finding that race is correlated with prompt refinancing).

²¹⁷ ESSENE & APGAR, *supra* note 94, at 23. *See also* Morgenson, *supra* note 95 (stating that in December 2006, in an agreement with the New York State Attorney General, Countrywide agreed “to compensate black and Latino borrowers to whom it had improperly given high-cost loans in 2004”).

²¹⁸ *Latino Credit Card Use: Debt Trap or Ticket to Prosperity?*, ISSUE BRIEF: EXECUTIVE SUMMARY Feb. 15, 2007, at 1 (Nat’l Council of La Raza, Wash., D.C.), available at http://www.nclr.org/files/44288_file_IB17_ExecuSumm_FNL.pdf.

²¹⁹ *Id.* at 2 (alterations in original).

borrowers have no credit score, which makes it difficult for them to obtain credit at favorable rates.²²⁰

Payday lenders and subprime mortgage companies target minority neighborhoods. In Chicago, for example, 41% of the city's subprime refinancing occurs in black neighborhoods, although only 10% of the overall refinancing takes place in these same neighborhoods.²²¹ An Illinois study found that there were 37% more payday loans issued in minority neighborhoods than in white neighborhoods.²²² The presence of these lenders in poorer, minority neighborhoods is not surprising. After all, payday loans and subprime mortgages are designed to extend credit to borrowers who are denied access to traditional credit products. Nevertheless, the broad exposure of minorities to payday loans and subprime mortgages implies a broad exposure to the risks associated with these products.

Women may also be disproportionately harmed by unsafe financial products. A recent survey found that "two-thirds of women graded themselves at C or lower in their knowledge of financial services or products."²²³ Another recent study found that older women display much lower levels of financial literacy than the older population as a whole.²²⁴ An inadequate understanding of financial products is likely to result in more welfare-reducing mistakes.

Finally, there is evidence that legal intervention aimed at curing mistakes in consumer credit markets does not help all consumers to the same extent. In particular, there is evidence that "the beneficial effects of [TILA] in enabling consumers to better shop for attractive loans may have been limited to well-educated, affluent borrowers."²²⁵ And the recent Federal Reserve study, which examined the efficacy of TILA disclosures, concluded:

[O]ne important finding has been that there are a number of consum-

²²⁰ *Id.*

²²¹ U.S. DEP'T OF HOUS. & URBAN DEV., UNEQUAL BURDEN: INCOME & RACIAL DISPARITIES IN SUBPRIME LENDING IN AMERICA 5 (2000), available at http://www.huduser.org/publications/pdf/unequal_full.pdf.

²²² MARTI WILES & DANIEL IMMERGLUCK, WOODSTOCK INST., REINVESTMENT ALERT NUMBER 14: UNREGULATED PAYDAY LENDING PULLS VULNERABLE CONSUMERS INTO SPIRALING DEBT 7 (2000), available at <http://woodstockinst.org/document/alert.pdf>.

²²³ John Leland, *Baltimore Finds Subprime Crisis Snags Women*, N.Y. TIMES, Jan. 15, 2008, at A1 (citing a 2006 survey by Prudential Financial).

²²⁴ Annamaria Lusardi & Olivia S. Mitchell, *Planning and Financial Literacy: How Do Women Fare?* (Nat'l Bureau of Econ. Research, Working Paper No. W13750, 2008), available at <http://www.nber.org/papers/w13750.pdf>.

²²⁵ Hynes & Posner, *supra* note 30, at 194 (citing a collection of studies).

ers who lack fundamental understanding of how credit card accounts work. These participants tended to be those with lower educational levels, and were likely subprime consumers (i.e., those with low credit scores). Unfortunately, this population is generally charged higher fees and interest rates than other consumers, and thus has the most at stake in understanding how these charges are calculated and how they can be avoided.²²⁶

The burden of credit-market imperfections are not spread evenly across economic, educational, or racial groups. The wealthy are insulated from many credit traps, while the vulnerability of working- and middle-class families increases. For those closer to the economic margin, a single economic mistake—a credit card with an interest rate that unexpectedly escalates to 29.99% or misplaced trust in a broker who recommends a high-priced mortgage—can trigger a downward economic spiral from which no recovery is possible.

D. *Summary: The Markets for Consumer Credit Products Are Failing*

Theory predicts and data confirm that markets for credit products are failing. Consumers, their families, their neighbors, and their communities are paying a high price for systematic cognitive errors. Creditors have aligned their products to exploit such errors, driving up costs for many consumers. Competition for manufactured products has produced a wide array of consumer-friendly features: ease of use, lower prices, more style, and hundreds of innovations that consumers have enjoyed. Competition in the credit market has similarly produced valuable products and features. But it has also produced an array of risky products and unsafe features. Twenty years ago, no one had heard of universal default, overlimit fees, liar's loans, teaser mortgages, payday rollovers, or the dozens of other innovations that have exploited consumers' imperfect understanding of complex credit products. Regulation assured that no manufacturer had to compete with another manufacturer who was willing to produce an unsafe product for less money. But regulation has not built the same floor under financial products. To restore efficiency to consumer credit markets, the same kind of basic safety regulation is needed.

²²⁶ DISCLOSURE EFFICACY STUDY, *supra* note 50, at 52.

II. THE SOLUTION

A. *Existing Responses and Why They Failed*

The lynchpin of consumer credit regulation was usury law. Harking back to biblical times, through to the foundation of the American colonies, and later of the American states, usury laws regulated credit by imposing a cap on the interest rate that any lender could charge. With a clear upper bound on the price of credit, incentives to raise prices while obscuring the total cost of borrowing were low. In 1978, a Supreme Court interpretation of ambiguous language in a national banking law effectively abolished state usury laws.²²⁷ By the 1990s, product innovation, from payday lending to universal default to creative mortgage financing, took root without much regulatory scrutiny.

While the states still play some role, state law has largely been preempted by federal legislation. We begin our survey of existing solutions with an overview of common law approaches to the regulation of consumer credit. After discussing the shortcomings of the *ex post*, common law approach, we turn to *ex ante* regulation. We discuss the multiple-regulators problem and the regulatory arbitrage opportunity it creates, starting with federal versus state regulators and ending with the multiplicity of federal regulators. Beyond the multiple-regulators problem, we argue that no single regulator has the necessary combination of motivation and authority to effectively regulate consumer credit products.

1. *Ex Post* Judicial Intervention

a. *Existing Ex Post Solutions*

There are essentially two *ex post* judicial tools available to protect consumers. The first is the common law of contracts, and the second is the fallback protection of bankruptcy. Both offer consumers some protection against dangerous credit products. But as ways to overcome the dangers facing consumers in the financial marketplace, both have serious systemic limitations.

²²⁷ In 1978, the Court allowed a Nebraska bank to export credit card rates to Minnesota. *Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 318 (1978). The credit card companies soon generalized the principle. Citibank moved its operations to South Dakota, which had a high interest rate cap, and Delaware soon raised its usury rate to attract more credit card business.

Consumer credit transactions are regulated by the general law of contracts. The main doctrinal vehicle for policing these transactions is the unconscionability doctrine.²²⁸ This doctrine gives courts broad power to strike down contract terms and entire contracts that shock the conscience and are the product of a flawed bargaining procedure.²²⁹ Unconscionability review is most commonly applied to contracts between consumers and sophisticated corporations,²³⁰ and it has been used to police credit contracts.²³¹ Yet courts have been very circumspect in applying unconscionability review to credit contracts.²³² As explained below, the reluctance of common law judges to intervene in credit transactions is justified by institutional, doctrinal, and procedural considerations.²³³ Moreover, with respect to interest rates and possibly other contractual provisions that form the centerpiece of credit contracts, unconscionability review is likely preempted by federal law.²³⁴

²²⁸ See U.C.C. § 2-302 (2007); RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

²²⁹ See E. ALLAN FARNSWORTH, CONTRACTS § 4.28, at 314 (3d ed. 1999) (explaining the doctrine of unconscionability generally as it is invoked by consumers, and discussing its use in franchise disputes).

²³⁰ See, e.g., *id.* (discussing the application of unconscionability to contracts when there is disparity of sophistication among the parties).

²³¹ See Posner, *supra* note 199, at 304-05 (discussing the application of unconscionability analysis in credit cases where lenders set exorbitantly high credit prices to offset risk).

²³² For example, courts have generally rejected unconscionability claims made against arbitration clauses in credit card contracts. See, e.g., *Arriaga v. Cross Country Bank*, 163 F. Supp. 2d 1189, 1194-95 (S.D. Cal. 2001) (finding that a credit card contract's arbitration clause was neither procedurally nor substantively unconscionable); *Bank One, N.A. v. Coates*, 125 F. Supp. 2d 819, 830-36 (S.D. Mass. 2001) (ruling against unconscionability even where an arbitration clause required plaintiff to bear arbitration fees and restricted available remedies); *Marsh v. First USA Bank, N.A.*, 103 F. Supp. 2d 909, 920 (N.D. Tex. 2000) (holding that the arbitration was not unconscionable though the clause was not bargained for). Such claims have been upheld, but only in extreme cases. See, e.g., *Ferguson v. Countrywide Credit Indus.*, 298 F.3d 778, 785 (9th Cir. 2002) (showing that an arbitration clause that exempts drafter's claims is most likely to be unconscionable); *Lozada v. Dale Baker Oldsmobile, Inc.*, 91 F. Supp. 2d 1087, 1105 (W.D. Mich. 2000) ("[A]n arbitration provision is substantively unconscionable because it waives class remedies, as well as declaratory and injunctive relief."); see also *Korobkin, supra* note 30, at 1274-75 (discussing arbitration-clause unconscionability cases).

²³³ See *infra* Part II.A.1.b.

²³⁴ See *infra* Part II.A.2.a; see also *Cade v. H & R Block, Inc.*, No. 1454-21, 1993 U.S. Dist. LEXIS 19041, at *15-18 (D.S.C. 1993) (reviewing the preemption of state unconscionability claims for refund-anticipation loans, but essentially stating that states' attempts to regulate credit card interest rates and other contractual provisions would be similarly preempted).

With the prevalence of penalty fees in credit transactions, a second common law doctrine—the penalty doctrine—could also be used to police consumer credit contracts. Contract law precludes the specification of damages for nonperformance that exceeds the true harm to the breached-against party, or a reasonable *ex ante* (at the time of contracting) estimate of such harm. Such excessive damages are considered an unlawful penalty, and as such are not enforceable.²³⁵ At least in some cases, the large penalties specified in consumer credit contracts clearly exceed the actual harm caused to the lender, as well as any reasonable *ex ante* estimate of such harm. For example, when a credit-card holder is required to pay a \$30 fee for missing the due date on a \$10 balance by only a day, the harm to the issuer is smaller, probably much smaller, than \$30. The attempt to collect \$30 is arguably an unlawful penalty.²³⁶ Thus far, however, few courts have so ruled.²³⁷

The ever-present option that a financially troubled consumer will file for bankruptcy and discharge all outstanding debt obligations imposes some regulatory oversight on consumer credit markets. In theory, lenders can be deterred from offering unsafe credit products by the threat that debt incurred through such unsafe products will be discharged in bankruptcy. The potential efficacy of such a threat is evident from lenders' intense lobbying to restrict consumers' access to bankruptcy. These lobbying efforts have been successful. Recently, in the Bankruptcy Abuse Prevention and Consumer Protection Act of

²³⁵ See U.C.C. § 2-718(1) (2007); RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981).

²³⁶ One commentator has even questioned the constitutionality of credit card late fees. See Seana Valentine Shiffrin, *Are Credit Card Late Fees Unconstitutional?*, 15 WM. & MARY BILL RTS. J. 457, 475-487 (2006) (arguing that state and federal laws regulating credit card penalties may allow credit card companies to impose late fees on consumers that far exceed the limits imposed by the Supreme Court's decision in *State Farm Mutual Automobile Insurance Co. v. Campbell*, 538 U.S. 408 (2003)).

²³⁷ See, e.g., *Hitz v. First Interstate Bank*, 44 Cal. Rptr. 2d 890 (Cal. Ct. App. 1995) *Beasley v. Wells Fargo Bank*, 1 Cal. Rptr. 2d 446, 448 (Cal. Ct. App. 1991) (finding that bank's "late" and "overlimit" fees were illegal liquidated damages in a class action suit); see generally Gary D. Spivey, Annotation, *Validity and Construction of Provision Imposing "Late Charge" or Similar Exaction for Delay in Making Periodic Payments on Note, Mortgage, or Instalment Sale Contract*, 63 A.L.R. 3d 50, 59 (1975) (discussing courts' interpretations of credit card fees as enforceable liquidated damages and not additional interest).

2005 (BAPCPA)²³⁸, Congress constrained consumers' ability to discharge credit card debt.²³⁹

Before BAPCPA was signed into law, courts struggled with the issue of debt dischargeability. In the credit card debt context, this struggle was often initiated by issuers' attempts to prevent dischargeability by accusing consumers of fraud under 11 U.S.C. § 523(a)(2)(A). Over time, the courts limited the scope of the fraud exception. For example, the Supreme Court, in *Field v. Mans*,²⁴⁰ formulated a subjective test, according to which the debtor's intent to repay is sufficient to make the debt dischargeable, precluding the creditor from making an allegation that the debtor defrauded the company by using a credit card when he was unable to pay.²⁴¹

The courts have also scrutinized the marketing techniques and screening procedures employed by credit card issuers, ruling that, in some cases, overzealous solicitation without sufficient inquiry into the consumer's ability to pay precludes any claim of nondischargeability.²⁴² Scrutiny of the contractual design itself could be the next step. Courts could use unsafe product design as a shield against a lender's

²³⁸ Pub. L. No. 109-8, 119 Stat. 23 (codified in scattered sections of 11 U.S.C.).

²³⁹ Issuers have also taken to the courts, increasing their challenges against the dischargeability of credit card debt based on 11 U.S.C. § 523(a)(2)(A) (2006). See Margaret Howard, *Shifting Risk and Fixing Blame: The Vexing Problem of Credit Card Obligations in Bankruptcy*, 75 AM. BANKR. L.J. 63, 110-140 (2001) (addressing the common law requirement of justifiable reliance in cases involving fraudulent debtors, and arguing for a rigorous standard of fraud).

²⁴⁰ 516 U.S. 59, 77 (1995).

²⁴¹ Cf. David F. Snow, *The Dischargeability of Credit Card Debt: New Developments and the Need for a New Direction*, 72 AM. BANKR. L.J. 63, 79-80 (1998) (arguing that when *Field v. Mans* found credit card debt dischargeable irrespective of the debtor's financial condition the court departed from the common law standard); Alane A. Becket, *Fifth Circuit Sets Its Standard for Credit Card Non-dischargeability*, AM. BANKR. INST. J., Oct. 2001, at 14 (2001) (analyzing the Fifth Circuit's standard for credit card nondischargeability, established in *In re Mercer*, 211 F.3d 214 (5th Cir. 2000)); Richard H. Gibson, *Credit Card Dischargeability: Two Cheers for the Common Law and Some Modest Proposals for Legislative Reform*, 74 AM. BANKR. L.J. 129, 153-55 (2000) (explaining the three-step process for applying the legal standard of justifiable reliance established in *Field v. Mans* to common law credit card cases); John D. Sheehan, *The 9th Circuit Clarifies Intent on Credit Card Debt Dischargeability*, AM. BANKR. INST. J., July/Aug. 1997, at 16 (1997) (reassessing the Ninth Circuit's use of a totality of the circumstances standard to determine fraudulent intent in light of *Field v. Mans*).

²⁴² See Snow, *supra* note 241, at pt. III.B.3 (stating that where courts have considered industry credit screening practices, they have found that the creditors failed to establish justifiable reliance); see also Howard, *supra* note 239, at 79-80 (stating that the behavior of the creditor should also be considered in determining dischargeability, as it is in common law fraud).

claim of nondischargeability. In addition, unsafe product design can theoretically be used not only as a shield, but also as a sword to exclude credit card issuers from any recovery in bankruptcy.²⁴³ Once again, however, the protection is more theoretical than actual.

Contract law and bankruptcy law together provide some protection for consumers who get into trouble with dangerous credit products. A consumer may raise some defenses in contract law to avoid the obligation to pay, or, if the impact is severe enough, the consumer may file for bankruptcy to discharge all debts, including those involving dangerous credit products. This protection, however, has substantial limits.

b. *The Failure of Existing Ex Post Solutions*

The ex post common law approach is not well suited for the regulation of consumer credit markets. It is not surprising that courts have been reluctant to try to regulate these markets using general contract law doctrines and bankruptcy law rules. The problem is not with particular judges; it is systemic. Concerns about institutional competence, doctrinal limitations and procedural barriers justify the observed judicial restraint.

i. Institutional Competence

Effective regulation of consumer credit markets requires information that is more readily accessible to regulatory agencies than to courts. For example, while the penalty doctrine may well be used in extreme cases to strike down late-fee provisions in credit card contracts,²⁴⁴ courts will often find it difficult to conduct the comprehensive analysis of an issuer's cost structure that would be required to separate illegal penalties from reasonable liquidated damages. Moreover, in many cases, even a thorough understanding of a single lender's business is insufficient for effective regulation. Rather, a broader perspective is needed—a perspective that encompasses market structure and demand characteristics. As the required informa-

²⁴³ Cf. *In re Jordan*, 91 B.R. 673, 680 (Bankr. E.D. Pa. 1988) (showing a debtor objection to a proof of claim in a Chapter 13 bankruptcy proceeding asserting illegal late charges imposed by a creditor). An even more extreme approach, borrowing from the concept of lender liability in the commercial-bankruptcy context, would render the issuer liable to the bankrupt consumer's other creditors. See 5-79 COLLIER BANKRUPTCY PRACTICE GUIDE, ¶ 79.05 (2003).

²⁴⁴ See *supra* Part II.A.1.a.

tion and analysis extend beyond the facts of any specific case, the relative institutional advantage shifts from courts to regulatory agencies. The single-plaintiff structure of contract litigation makes inquiry into a range of different practices very difficult, particularly when some of the practices may have affected the particular plaintiff who is asserting a problem and some may not have. This plaintiff-centered perspective further limits a court's view of the problem.

The comparative institutional disadvantage of courts has been previously noted in the more general context of consumer contracts. Lewis Kornhauser argued that imperfections in consumer markets may be more amenable to legislative rather than to judicial correction.²⁴⁵ With respect to disclosure regulation, Richard Craswell has recently argued that common law courts applying contract law doctrine on a case-by-case basis are at an institutional disadvantage compared with regulators who enjoy a broader market perspective.²⁴⁶ Kip Viscusi, Richard Epstein and Alan Schwartz have similarly argued that safety warnings should be designed by regulatory agencies, not by common law courts.²⁴⁷ Lawyers are well schooled in the notion of using single-plaintiff litigation to right legal wrongs. But in the field of regulation of consumer credit markets, there is substantial consensus that such litigation is ill suited to produce the most effective results.

ii. Doctrinal Limitations

The main doctrinal tool for policing consumer credit markets is the contract-law doctrine of unconscionability. The limits of the unconscionability doctrine, largely shared by alternative doctrines, explain the inadequacy of an *ex post*, common law approach to the

²⁴⁵ See Kornhauser, *supra* note 1, at 1180-81 (arguing that market imperfections leading to unconscionable contracts may be more amenable to legislative rather than to judicial correction).

²⁴⁶ Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere*, 92 VA. L. REV. 565, 592-93 (2006); see also Beales et al., *supra* note 30, at 528; Schwartz & Wilde, *Imperfect Information*, *supra* note 37, at 1456-59 (arguing that case-by-case judicial decisions are a poor mechanism for implementing general bans due to the deciding courts' limited access to important information).

²⁴⁷ See RICHARD EPSTEIN, *MODERN PRODUCTS LIABILITY LAW* 110-12 (1980); W. KIP VISCUSI, *REFORMING PRODUCTS LIABILITY* 155-56 (1991) (arguing that a common law establishment of warnings will reduce their value by causing firms to be overly conservative, and recommending a standardized warning system); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 398 & n.90 (1988) (questioning the effectiveness of common law warnings because of jury speculation on the adequacy of warnings).

regulation of consumer credit markets. As currently interpreted, the unconscionability doctrine is too narrow to address many of the problems in the consumer credit market. For example, it would not be considered unconscionable for a credit card issuer to offer consumers a choice between (1) a credit card with a zero-percent teaser rate and a high long-term rate, and (2) a credit card with no teaser rate but a lower long-term rate. This strategy might impose significant costs on ill-informed consumers, but would never come close to the standards necessary to find unconscionability.

A possible response is to interpret unconscionability more broadly. Such a move, however, runs a substantial risk of doing more harm than good. Substantial expansion of the doctrine of unconscionability would have consequences far outside the realm of credit products and well into markets that may not suffer from the same defects. In theory, courts could develop a special, broader unconscionability doctrine that would apply only to credit contracts. More generally, courts could develop a series of market-specific unconscionability doctrines for each consumer market. These market-specific doctrines would be based on a fact-intensive inquiry of market conditions and practices. But such an approach would entail a sharp departure from current unconscionability jurisprudence—a departure that institutional and procedural considerations advise against.

Doctrinal constraints similarly limit the efficacy of regulation through bankruptcy law. Specifically, the courts are not free to write on a clean slate. Provisions designed to protect debtors from overreaching creditors are often tangled enough to leave plenty of room for those creditors to make strong claims for collection. The courts' struggle with Section 523(a)(2)(A), for example, has not been an easy one.²⁴⁸

²⁴⁸ Compare *In re Dougherty*, 84 B.R. 653, 657 (B.A.P. 9th Cir. 1988) (formulating a totality of the circumstances test examining a nonexclusive list of twelve objective factors relevant to dischargeability), with *In re Eashai*, 87 F.3d 1082, 1088 (9th Cir. 1996) (rejecting the totality of the circumstances test from *In re Dougherty* and requiring proof of false representation, intent to deceive, justifiable reliance, and actual damages). See generally *In re Rembert*, 141 F.3d 277, 281 (6th Cir. 1998) (stating that the use of a credit card implies a representation of an intention but not an ability to pay); *In re Hashemi*, 104 F.3d 1122, 1126 (9th Cir. 1997) (requiring creditor to show only that, as a whole, relevant evidence indicates debtor intended to pay); *In re Anastas*, 94 F.3d 1280, 1285 (9th Cir. 1996) (interpreting "intent to deceive" factor to require investigation only of whether debtor intended to pay, not whether debtor had the ability to pay); *In re Ward*, 857 F.2d 1082, 1084 (6th Cir. 1988) (requiring a credit check as a precondition for justifiable reliance).

iii. Procedural Barriers

Unlike harm caused by noncredit consumer products, which is commonly a low-probability but high-magnitude harm, the harm caused by consumer credit products is typically a high-probability, low-magnitude harm.²⁴⁹ An unsafe consumer credit product often harms many consumers, but the harm to each consumer is usually small. As a result, litigation is a far less effective tool to deal with dangerous financial products than to deal with dangerous physical products.

Credit card fees provide a ready example. Compared with their reluctance to invoke the unconscionability doctrine, courts have been somewhat more susceptible to penalty-doctrine claims raised against various fees in consumer credit contracts.²⁵⁰ Nonetheless, the sharp growth in penalty fees over the past decade, and the increasing fraction of profits they produce for credit card issuers, suggest that consumer efforts to resist fee charges have had minimal impact across the market. According to the GAO, late fees averaged \$12.83 in 1995. They soared 162%, to an average of \$33.64 in 2005.²⁵¹ In 2005, penalty fees, which include late fees, overlimit fees, and a few others, accounted for 7.2% of issuer revenues, or \$7.88 billion.²⁵² While not all these fees would be illegal if scrutinized under the current penalty doctrine, this increase was produced in large part by late fees and overlimit fees that are not always tied to the actual or estimated losses the creditor suffers as a result of the consumer's "breach."

But the odds are small that these fees could be meaningfully challenged by lawsuit. A single fee is often small; the average late payment fee imposed by credit card companies is now \$35.²⁵³ The aggregate effect may be huge, but it makes little economic sense for any single borrower to litigate such a modest amount. Even high interest charges, which may seem huge to the borrower, would be dwarfed by the costs of litigation and subsequent appeals. Families who have problems with credit are unlikely to have the resources to pursue judicial remedies.

²⁴⁹ See *supra* Introduction.

²⁵⁰ In particular, several such claims have been accepted against late and overlimit fees in credit card contracts. See *supra* note 237.

²⁵¹ See GAO, INCREASED COMPLEXITY REPORT, *supra* note 18, at 18.

²⁵² See eCID (the electronic version of Card Industry Directory), Analysis, Industry Statistics section, <http://www.cardforum.com/staticpage.html?pagename=ecidinfo>.

²⁵³ Thomas Redman, *Late Payment Fees*, CARDTRAK.COM, Apr. 20, 2007, http://www.cardtrak.com/news/2007/04/20/late_payment_fees.

Other aspects of credit card practices further undercut the effectiveness of any judicial remedy for fee charges or other harmful terms. The widespread inclusion of arbitration clauses in standard credit card contracts inoculates lenders against the possibility of class action lawsuits, which would otherwise change the economics of pursuing debtor's rights.²⁵⁴ Other contract terms have similar effects. Forum-selection clauses and contractual provisions to shift the cost of all attorneys' fees to the loser can further increase the costs—and the risks—of litigation as a meaningful way to protect borrowers.

Regulation through bankruptcy presents its own systemic problems. Even in bankruptcy court, which is often more informal, the costs of litigation will far outstrip any benefits for many debtors, making resistance to creditors' efforts to collect a problematic economic calculation. BAPCPA further increased costs, driving up attorneys' fees, increasing paperwork, creating time delays, and erecting extra hurdles on the way to a discharge. Filing fees have also increased. Even if consumers manage to scale all the newly erected barriers, they discover that post-BAPCPA the courts' power to protect consumers has been limited. Because most credit card debt listed in bankruptcy is currently discharged, bankruptcy courts have little room at the margins to influence the creditors' bottom lines by declaring certain practices off limits. Perhaps the most significant limitation on the capacity of the bankruptcy system to provide effective consumer regulation is that relatively few consumers pass through its doors. Although bankruptcy filings have climbed over the past decade, the number of filers

²⁵⁴ See Korobkin, *supra* note 30, at 1274-75 (finding that courts generally uphold arbitration clauses, though some have struck agreements that explicitly preclude class actions). Arguably, this problem could be remedied by legislation or court rulings that ensure access to class action litigation (or arbitration). Such legal reform is, however, unlikely in the foreseeable future, given lenders' relative political strength. Interestingly, arbitration clauses, and specifically arbitration clauses precluding class actions, are much more common in consumer contracts than in business-to-business contracts. See Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly-Held Companies*, 56 DEPAUL L. REV. 335, 373 (2007) (noting that, although large corporations do not embrace arbitration in their agreements with other corporations, lenders and credit card issuers insist on such clauses in consumer contracts); Theodore Eisenberg, Geoffrey Miller & Emily L. Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REFORM 871 (2008) (reporting that more than three-quarters of contracts between studied companies and consumers contained arbitration clauses, while less than 10% of the companies' "negotiable, non-consumer, nonemployment" contracts had similar clauses).

and the amount of debt they carry are mere specks on the overall \$2.5 trillion consumer credit industry.²⁵⁵

2. Ex Ante Regulation

The effectiveness of ex post judicial regulation of consumer credit products is severely limited. But ex ante regulation, as currently constructed, faces substantial limits as well. First, state law, which in many cases took the lead on consumer protection issues, is being increasingly preempted by federal law. Second, current ex ante regulation excessively relies on legislation, which cannot effectively respond to market innovation. Third, and most importantly, despite the multiplicity of regulators, there is no single regulator that has both the authority and motivation to police the safety of consumer credit products.

a. *The Erosion of State Power*

The United States has a dual banking system. This dual system allows financial institutions a variety of options for organizing themselves under state or federal law. They may become nationally- or state-chartered banks, thrifts, or credit unions.²⁵⁶ This variety provides lenders with some choice between federal and state regulation. In particular, banks choosing a federal charter can do business in a state,

²⁵⁵ See Federal Reserve Statistical Release, G19: Consumer Credit (June 6, 2008), <http://www.federalreserve.gov/releases/g19/20080606/> (listing the total outstanding consumer credit for the month of April, 2008 as being in excess of 2.5 trillion dollars).

²⁵⁶ One commentator has described banks' different options for organization:

In commercial banks, for example, there are four possible patterns of regulation: (1) national banks, federally chartered by the Comptroller of the Currency, which automatically are members of the Federal Reserve System and insured by the Federal Deposit Insurance Corporation (FDIC) (currently, most of the very large banks are national banks); (2) state chartered banks, also members of the Federal Reserve System and therefore insured by the FDIC; (3) state banks insured by the FDIC but not members of the Federal Reserve System (most of the numerous small state banks are in this category); (4) state banks operating without federal deposit insurance. Few banks are in this last category because lack of federal deposit insurance is seen as competitively too disadvantageous.

Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 3 (1977) (footnotes omitted); see also Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More Than They Can Chew?*, 56 AM. U. L. REV. 515, 515-16 (2007) (describing the creation of the dual banking system in the United States).

but avoid regulation under that state's laws—particularly under that state's consumer protection laws.

In the past, all financial institutions—federally chartered national banks and state banks as well—were subject to the laws of the borrower's state, especially to the usury laws in the borrower's state.²⁵⁷ This changed in the late 1970s when the United States Supreme Court, interpreting the word “located” in section 85 of the National Bank Act (NBA),²⁵⁸ decided that national banks are governed by the usury laws of the state where their headquarters are located, not by the usury laws of the state where the customer is located.²⁵⁹ In 1996,

²⁵⁷ William Eskridge, collects and discusses a number of sources regarding the history of usury laws. William Eskridge, *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083 (1984). These include Jeremiah W. Blydenburgh, *A Treatise on the Law of Usury* (1844), which reprints mid-nineteenth-century usury laws from each state; Sidney Homer, *A HISTORY OF INTEREST RATES* (2d ed. 1977), which traces and analyzes interest rates across various investment instruments across the United States from the colonial period into the 1970s; and Franklin W. Ryan, *USURY AND USURY LAWS* (1924), which chronicles the debate over the repeal of usury laws in the mid-nineteenth century, and describes early-twentieth-century attempts to combat loan-sharking and other “immoral” lending practices.

²⁵⁸ 12 U.S.C. § 85 (2006).

²⁵⁹ See *id.* (“Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located . . .”). In 1978, the Supreme Court held that this provision of the National Bank Act gave national banks “most favored lender” status in their home state and also allowed national banks to “export” their home-state interest rates to borrowers residing in other states. See *Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299, 301 (1978) (affirming the Minnesota Supreme Court’s holding that the NBA “authorizes a national bank based in one state to charge its out-of-state credit-card customers an interest rate . . . allowed by its home state, even though that rate is greater than that permitted by the state of the bank’s nonresident customers”). For a comprehensive analysis of the “most favored lender” and “exportation” doctrines, see Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 544-617 (2004). Congress granted “most favored lender” status and “exportation” authority to FDIC-insured state banks and thrift institutions in 1980. See *id.* at 565-67 (discussing 12 U.S.C. § 1831d, which applies to all FDIC-insured state banks); *id.* at 601-03 (discussing 12 U.S.C. § 1463(g)(1), which applies to federally chartered thrift institutions). See also *Credit Card Practices: Current Consumer and Regulatory Issues: Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs.*, 110th Cong. 70 (2007) (written testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School) [hereinafter Wilmarth Testimony] (describing the holding of *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*). The Supremacy Clause of the United States Constitution, U.S. CONST. art. VI, cl. 2, gives the OCC the power to use the NBA, a federal statute, to preempt state law. See Mark Furletti, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate*

the Court extended this ruling to any payment compensating a creditor for an extension of credit, including numerical periodic rates, annual and cash-advance fees, bad-check fees, overlimit fees, and late-payment fees.²⁶⁰ As a result, state interest rate regulation has been effectively preempted. Currently, any lender with a federal bank charter can locate its operations in a state with high usury rates (e.g., South Dakota or Delaware) and then export that interest rate to customers located anywhere else in the country.²⁶¹ States have become powerless to protect their citizens from such lending practices going on within their borders.²⁶² It is noteworthy that state-level interest rate and fee regulation is not preempted by corresponding federal regulation. Rather, the preemption follows from the federally defined rules applicable only to federally chartered banks. Specifically, the NBA rule that interstate lending is subject to the laws of the state in which the lender is headquartered triggered interstate regulatory competition to attract lenders, and this competition effectively eliminated state-level price regulation.

In addition, direct federal preemption works to undermine state law in areas other than interest rate and fee regulation. Recently, the federal government has used its powers under the Supremacy Clause of the U.S. Constitution to preempt more and more state law.²⁶³ In 2004, the OCC issued a regulation (the “activities preemption regulation”) that expanded the scope of preemption. The OCC insulated all banks carrying its charter from any state laws that it deemed to

Credit Cards, 77 TEMPLE L. REV. 425, 426 (2004) (citing repeated rulings by various courts upholding the OCC’s power to preempt state law under the NBA).

²⁶⁰ See *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 744-45 (1996) (upholding the validity of 12 C.F.R. § 7.4001(a)); see also Schiltz, *supra* note 259, at 560-65 (discussing *Smiley* and the OCC’s expansive interpretation of “interest” under 12 U.S.C. § 85); Wilmarth Testimony, *supra* note 259, at 70).

²⁶¹ “In addition, the OCC issued a ruling in 1998 that allows a national bank to ‘export’ the ‘interest’ allowed by the law of any state in which the bank maintains either its main office or a branch.” Wilmarth Testimony, *supra* note 259, at 70; see also Schiltz, *supra* note 259, at 553-56 (discussing OCC Interpretive Letter. No. 822 (Feb. 17, 1998)). On the deregulation of interest rates in the home mortgage market, see Eskridge, *supra* note 257, at 1107-10; Willis, *supra* note 90, at 718.

²⁶² On regulatory competition in the banking system, see Scott, *supra* note 256. Such regulatory competition generates negative interjurisdictional externalities. South Dakota enjoys tax revenues from banks that choose to locate in the state, while those banks enjoy profits generated by interest rates charged to customers in California and Massachusetts—profits that legislatures in California and Massachusetts specifically prohibit. Banks in haven states impose costs that are borne largely by consumers in other states.

²⁶³ Peterson, *supra* note 256, at 516.

“obstruct, impair, or condition a national bank’s ability to fully exercise its Federally authorized powers’ in four broadly-defined areas—viz., real estate lending, lending not secured by real estate, deposit-taking, and other ‘operations.’”²⁶⁴ This regulation cancels out much state-level consumer protection law.²⁶⁵

It is not surprising that a number of banks have switched from state to federal charters. Examples of such regulatory arbitrage are the recent decisions by JPMorgan Chase, HSBC, and Bank of Montreal (Harris Trust) to convert from state to national charters—

²⁶⁴ Wilmarth Testimony, *supra* note 259, at 72 (quoting 12 C.F.R. §§ 7.4008 (lending not secured by real estate), 7.4007 (deposit-taking), 7.4009 (other “operations”), 34.4(a) (real estate lending) (2008)). These regulations were recently upheld by the Supreme Court. See *Watters v. Wachovia Bank, N.A.*, 127 S. Ct. 1559, 1564-65 (2007). See also JONATHAN R. MACEY ET AL., *BANKING LAW AND REGULATION* ch. 7, sec. E. (4th ed., 2008); Elizabeth R. Schiltz, *Damming Watters: Channeling the Power of Federal Preemption of State Consumer Banking Laws*, 35 FLA. ST. U. L. REV. (forthcoming 2008), available at <http://papers.ssrn.com/abstract=1028886>; Robert M. Morgenthau, *Who’s Watching Your Money?*, N.Y. TIMES, Apr. 30, 2007, at A21. For a comprehensive analysis and critique of the OCC’s rules, see Arthur E. Wilmarth, Jr., *The OCC’s Preemption Rules Exceed the Agency’s Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004) [hereinafter Wilmarth, *OCC’s Preemption Rules*]. The OCC’s activities-preemption regulation is closely similar to preemptive rules previously issued by the Office of Thrift Supervision (OTS). See 12 C.F.R. §§ 545.2, 557.11, 560.2. These rules are discussed in Wilmarth, *OCC’s Preemption Rules*, *supra*, at 283-84. A previous OCC regulation, 12 C.F.R. § 7.4006, recently upheld by the Supreme Court, extends federal preemption to state-chartered operating subsidiaries of national banks. See *Watters*, 127 S. Ct. at 1572-73 (2007).

²⁶⁵ See Wilmarth Testimony, *supra* note 259, at 72-73 (arguing that the OCC only recognizes state laws when they increase the power of national banks); MACEY ET AL., *supra* note 264, ch. 7, sec. E (“[The OCC preemption rules] significantly undercut the states’ ability to promulgate effective consumer protection laws, since those laws may not apply to national banks or to their operating subsidiaries.”). The precise extent to which state consumer protection laws are preempted is unclear. See U.S. GOV’T ACCOUNTABILITY OFFICE, *OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS* (GAO-06-387) 10-17 (2006), available at <http://www.gao.gov/new.items/d06387.pdf> (questioning the applicability of state consumer protection laws in light of OCC preemption power); see also, Wilmarth Testimony *supra* note 259, at 73-74 (citing U.S. GOV’T ACCOUNTABILITY OFFICE, *supra*) (noting the GAO’s concern regarding the application of state consumer protection laws). But even when state law is not preempted, state-level enforcement is substantially impaired by the OCC’s “visitorial powers” preemption regulation, which gives the OCC exclusive power to enforce both state and federal laws against national banks. See 12 C.F.R. § 7.4000; see also Wilmarth Testimony, *supra* note 259, at 74 (“The combined effect of the OCC’s preemption regulations is to make the OCC the final arbiter of the scope of national bank powers, as well as the sole enforcement agency with respect to national banks and their operating subsidiaries.”); Wilmarth, *supra* note 264, at 228-29, 327-34 (discussing the regulation). The Second Circuit recently confirmed the validity of that regulation. See *Clearing House Ass’n v. Cuomo*, 510 F.3d 105, 120 (2d Cir. 2007).

decisions that removed more than \$1 trillion of banking assets from the state-regulated banking system. In April 2006, the Bank of New York, one of the largest remaining state banks, agreed to sell its 338 retail branches to JPMorgan Chase, thus merging one of the last large state operations into a national bank. Arguably, these significant structural changes in the banking industry were driven at least in part by the favorable regulatory environment that the OCC created for national banks.²⁶⁶

Mark Furletti of the Federal Reserve Bank of Philadelphia has observed that now almost any state statute designed to protect consumers is preempted by federal law.²⁶⁷ State law is reserved for state-chartered banks. State laws, once the principle source of consumer protection, can offer local citizens only modest protection. Many credit practices that a state may deem fraudulent, deceptive, or otherwise unlawful will be nonetheless permitted within state borders whenever federally chartered institutions are involved.

The current regulatory scheme thus has two systemic problems. By permitting the states to compete for business by offering less and less consumer protection, the regulation scheme starts to unravel. Moreover, federal regulations that preempt state consumer protection without substituting other protection schemes create large holes in the regulatory fabric that encourage lenders to use a national charter to evade local protection. The combination not only leaves consumers with little protection, it also creates structures in which the most aggressive lenders can pursue their tactics with impunity.

The erosion of state power in itself need not be problematic from a consumer protection perspective. In an era of interstate banking, uniform regulation of consumer credit products at the federal level may well be more efficient than a litany of consumer protection rules that vary from state to state. The problem is not in the federal preemption; it is in the failure of federal law to offer a suitable alternative to the preempted state law.

²⁶⁶ See Wilmarth, *supra* note 264, at 363-64 (arguing that the OCC's preemption rules incentivize nationalization of banks); see also Wilmarth Testimony, *supra* note 259, at 74-75 (citing examples of multistate banks converting to national charters due to OCC preemption rules).

²⁶⁷ See Furletti, *supra* note 259, at 426 (examining "regulatory consequences of the NBA's near total preemption of state statutes designed to protect credit card consumers").

b. *Regulatory Agencies, Not Legislators*

Two regulatory approaches fit within the *ex ante* framework. In one, regulation is the direct product of the legislature, passed one statute at a time. In the other, broad enabling legislation is implemented by a single, specialized regulatory agency that is charged with supervising consumer products within its portfolio. In effect, the difference is whether the ongoing regulation of a market is lodged with legislators or if the legislators have empowered the regulators to monitor the market and develop new and nuanced responses. A significant portion of current consumer protection law is based on a series of highly targeted statutes. These include the Truth in Lending Act,²⁶⁸ the Fair Credit Reporting Act,²⁶⁹ the Fair Debt Collection Practices Act,²⁷⁰ the Equal Credit Opportunity Act,²⁷¹ the Home Ownership and Equity Protection Act (HOEPA),²⁷² and many more.²⁷³ The main drawback of these statutes is their specificity. Each one identifies specific problems to be addressed and identifies within the statutory framework what practices will be outlawed and what practices will not. The specificity of these laws inhibits beneficial regulatory innovations, so that there is little innovation in such areas of consumer disclosure or developing responses to new financial devices. If a practice was not already well documented by the time Congress addressed the issue, regulatory inertia set in and the likelihood that it would be covered by

²⁶⁸ 15 U.S.C. §§ 1601–1613, 1631–1649, 1661–1667f (2006).

²⁶⁹ *Id.* §§ 1681–1681x.

²⁷⁰ *Id.* §§ 1692–1692p.

²⁷¹ *Id.* §§ 1691–1691f.

²⁷² *Id.* § 1639.

²⁷³ Examples of state-level legislation are also abundant. *See, e.g.,* Raphael W. Bostic et al., *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 3-8, 26 (August 7, 2007) (unpublished manuscript), *available at* <http://ssrn.com/abstract=1005423> (describing state-level “mini-HOEPA” statutes and other anti-predatory lending laws). Proposed legislation provides additional examples. Focusing on credit card regulation, *see, for example,* Joe Adler, *In Focus: Card Rules Have Fed, Lawmakers Far Apart*, AM. BANKER, May 29, 2007, at 1 (listing bills: Stop Unfair Practices in Credit Cards Act of 2007, S. 1395, 110th Cong. (2007) (introduced by Sens. Levin and McCaskill); Universal Default Prohibition Act of 2007, S. 1309, H.R. 2146, 110th Cong. (2007) (introduced in the Senate by Sen. Tester; introduced in the House by Reps. Ellison et al.); Credit Card Minimum Payment Warning Act of 2007, S. 1176, 110th Cong. (2007) (introduced by Sens. Akaka, Durbin, Leahy, and Schumer); Credit Card Repayment Act of 2007, H.R. 1510, 110th Cong. (2007) (introduced by Reps. Price et al.); Credit Card Accountability Responsibility and Disclosure Act of 2007, H.R. 1461, 110th Cong. (2007) (introduced by Reps. Udall and Cleaver)); Credit Card Payment Fee Act of 2007, H.R. 873, 110th Cong. (2007) (introduced by Reps. Ackerman and Maloney).

regulation was almost nil, even if the regulator had the formal authority to address the new practice. New practices, both good and bad, have occurred outside the regulatory framework, while old practices are rigidified even when better approaches become possible.²⁷⁴

In the race between regulation and market innovation, market participants have stronger incentives than regulators to change, and market participants face substantial incentives to test the boundaries of the regulatory framework. Regulation will invariably follow the market. In an optimal regulatory framework, regulation follows the market closely, without lagging far behind. Regulation through specific statutes does not allow for a timely and effective response to market innovations.

In an industry in which innovation is rapid, regulation through legislation is too clumsy and slow to be effective. This would be true even in a political environment amenable to frequent additions and adjustments to an evolving corpus of consumer protection legislation. The inadequacy of specific statutes is even more problematic in a political environment driven by powerful lobbying forces. The combined power of lenders, enhanced by their superior resources and their single-minded focus on credit-related issues, will nearly always drown out the power exercised by consumers. For example, even the basic—and largely uncontroversial—effort to require credit card companies to disclose how long it will take a customer to pay off a credit card balance if the customer makes only minimum monthly payments was stalled for years. Eventually, a watered-down and largely ineffective version of this important disclosure was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Section 1301.²⁷⁵

c. Mismatch of Authority and Motivation

Effective regulation requires both authority and motivation. Yet none of the many regulators in the consumer credit field satisfies these basic requirements. Federal banking regulators have the authority but not the motivation. For each federal banking agency, consumer protection is not first (or even second) on its priority list. By

²⁷⁴ This is not to say that specific legislation cannot have a positive effect. Sure it can. See, e.g., Bostic et al., *supra* note 273 (studying the effects of state-level antipredatory lending statutes).

²⁷⁵ § 1301, 15 U.S.C. § 1637 (2006).

contrast, the FTC makes consumer protection a priority, but it enjoys only limited authority over consumer credit markets.

i. The Banking Agencies: Authority Without Motivation

Five federal banking agencies exercise authority over various slices of the consumer credit market. The FRB, which is the central bank of the United States, directly supervises state-chartered banks that choose to become members of the Federal Reserve System.²⁷⁶ The Federal Reserve also serves as an umbrella supervisor of banks regulated under the other banking agencies.²⁷⁷ The Office of the Comptroller of the Currency, located within the Treasury Department, was created by Congress to oversee the national banking system.²⁷⁸ The OCC charters and supervises national banks. The Office of Thrift Supervision, also located within the Treasury Department, charters and supervises federal savings associations and also supervises state-chartered savings associations that belong to the Deposit Insurance Fund.²⁷⁹ The FDIC is “the primary federal regulator of state banks that are chartered by the states that do not join the Federal Reserve System[, yet take advantage of federal deposit insurance]. In addition, the FDIC is the backup supervisor for the remaining insured banks and thrift institutions.”²⁸⁰ Finally, the National Credit Union Administration (NCUA), an independent federal agency, charters and supervises federal credit unions. NCUA also “operates the National Credit Union Share Insurance Fund (NCUSIF)[,] insuring [savings accounts] in all federal credit unions and many state-chartered credit unions.”²⁸¹

²⁷⁶ KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS 30 (1983). The Fed’s enforcement authority is limited to these banks. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., PURPOSES AND FUNCTIONS 76 (2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf [hereinafter FRB, PURPOSES AND FUNCTIONS].

²⁷⁷ The Structure of the Federal Reserve System, <http://www.federalreserve.gov/pubs/frseries/frseri.htm> (last visited Oct. 1, 2008).

²⁷⁸ *See* Furletti, *supra* note 259, at 427 (citing legislative history of the NBA).

²⁷⁹ OFFICE OF THRIFT SUPERVISION, STRATEGIC PLAN (2000–2005) FOR THE OFFICE OF THRIFT SUPERVISION 1 (2000), <http://www.ots.treas.gov/docs/4/48103.pdf> [hereinafter OTS, PLAN]. The vast majority of state-chartered savings associations belong to the Deposit Insurance Fund.

²⁸⁰ Fed. Deposit Ins. Corp., Who Is the FDIC?, <http://www.fdic.gov/about/learn/symbol/index.html> (last visited Oct. 1, 2008).

²⁸¹ Nat’l Credit Union Admin., About NCUA, <http://ncua.gov/AboutNCUA/Index.htm> (last visited Oct. 1, 2008).

The banking agencies have authority to enforce the federal consumer credit laws. The Federal Reserve Board's consumer protection responsibilities include "[1] writing and interpreting regulations to carry out many of the major consumer protection laws, [2] reviewing bank compliance with the regulations, [3] investigating complaints from the public about state member banks' compliance with consumer protection laws."²⁸² Specifically, Congress charged the Federal Reserve with implementation of the TILA.²⁸³ TILA was passed in 1968 with the stated purpose of "assur[ing] a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."²⁸⁴ The Federal Reserve implemented TILA "by writing Regulation Z, which requires banks and other creditors to provide detailed information to consumers about the terms and cost of consumer credit for mortgages, car loans, credit and charge cards, and other credit products."²⁸⁵ In addition to the TILA, the Federal Reserve implements and enforces numerous other consumer protection

²⁸² See FRB, PURPOSES AND FUNCTIONS, *supra* note 276, at 75.

²⁸³ See *id.*, at 75-76 ("Congress passed the Truth in Lending Act to ensure that consumers have adequate information about credit. The Board implemented that law . . ."); see also A. Brooke Overby, *An Institutional Analysis of Consumer Law*, 34 VAND. J. TRANSNAT'L L. 1219, 1272 (2001) ("The archetype of all modern consumer disclosure statutes is perhaps the United States [TILA], which among other things requires creditors to disclose clearly and conspicuously the 'annual percentage rate' and 'finance charge' in consumer credit transactions." (footnotes omitted)); Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOY. CONSUMER L. REV. 43, 54 (2005) ("The most prominent example of the federal laws that regulate the extension of credit by banks is [TILA], which requires lenders to disclose the terms and cost of the loan." (footnote omitted)).

²⁸⁴ 15 U.S.C. § 1601(a) (2006). TILA has been amended several times to provide additional consumer protection. These amendments include (descriptions in parentheses quoted from FRB, PURPOSES AND FUNCTIONS, *supra* note 276, at 78-80): the Fair Credit Billing Act, 15 U.S.C. §§ 1666-1666j (2000), (specifies how creditors must respond to billing-error complaints from consumers, imposes requirements to ensure that creditors handle accounts fairly and promptly, and applies primarily to credit and charge card accounts); the Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, §§ 151-158, 108 Stat. 2190 (codified as amended in scattered sections of 12 U.S.C.) (providing additional disclosure requirements and substantive limitations on home equity loans with rates or fees above a certain percentage or amount); the Fair Credit and Charge Card Disclosure Act of 1988, Pub. L. No. 100-583, § 1 102 Stat. 2960 (codified as amended in scattered sections of 15 U.S.C.) (requiring that applications for credit cards that are sent through the mail, solicited by telephone, or made available to the public (for example, at counters in retail stores or through catalogs) contain information about key terms of the account).

²⁸⁵ FRB, PURPOSES AND FUNCTIONS, *supra* note 276, at 76.

laws.²⁸⁶ More generally, the FRB has broad authority under the Federal Trade Commission Improvement Act to prevent unfair or deceptive acts and practices.²⁸⁷

Regulations promulgated under these statutes are enforced directly by the Federal Reserve against state-chartered banks that chose to become members of the Federal Reserve System. Enforcement against other banks and financial institutions is carried out by the

²⁸⁶ The Federal Reserve also implements the following (descriptions in parentheses quoted from FRB, PURPOSES AND FUNCTIONS, *supra* note 276, at 78-81): the Fair Housing Act, 42 U.S.C. §§ 3601-3619 (2006) (prohibiting discrimination in the extension of housing credit on the basis of race, color, religion, national origin, sex, handicap, or family status); the Fair Credit Reporting Act, 15 U.S.C. §§ 1681-1681x (protecting consumers against inaccurate or misleading information in credit files maintained by credit-reporting agencies and requiring credit-reporting agencies to allow credit applicants to correct erroneous reports); the Equal Credit Opportunity Act, 15 U.S.C. §§ 1692-1692p (prohibiting discrimination in credit transactions on several bases, and requiring creditors to grant credit to qualified individuals without requiring co-signature by spouses, to inform unsuccessful applicants in writing of the reasons credit was denied, and to allow married individuals to have credit histories on jointly held accounts maintained in the names of both spouses); the Consumer Leasing Act of 1976, 15 U.S.C. §§ 1667-1667e (requiring that institutions disclose the cost and terms of consumer leases, such as automobile leases); the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692-1692p (prohibiting abusive debt collection practices); the Expedited Funds Availability Act (1987), 12 U.S.C. §§ 4001-4010 (specifying when depository institutions must make funds deposited by check available to depositors for withdrawal and requiring institutions to disclose to customers their policies on funds availability); the Home Equity Loan Consumer Protection Act of 1988, 15 U.S.C. §§ 1637a, 1647, 1665b (requiring creditors to provide consumers with detailed information about open-end credit plans secured by the consumer's dwelling and regulating advertising of home equity loans); the Truth in Savings Act, 12 U.S.C. §§ 4301-4313 (regulating the advertising of savings accounts, requiring that depository institutions disclose to depositors certain information about their accounts—including the annual percentage yield, which must be calculated in a uniform manner—and prohibiting certain methods of calculating interest); the Fair and Accurate Credit Transaction Act of 2003, Pub. L. No. 108-159, 117 Stat. 1952 (codified as amended in scattered sections of 15 U.S.C., 20 U.S.C.) (enhancing consumers' ability to combat identity theft, increasing the accuracy of consumer reports, allowing consumers to exercise greater control over the type and amount of marketing solicitations they receive, restricting the use and disclosure of sensitive medical information, and establishing uniform national standards in the regulation of consumer reporting).

²⁸⁷ Federal Trade Commission Improvement Act of 1980, 15 U.S.C. §§ 57b-1 to -4 (2006). This statute

[a]uthorizes the Federal Reserve to identify unfair or deceptive acts or practices by banks and to issue regulations to prohibit them. Using this authority, the Federal Reserve has adopted rules substantially similar to those adopted by the FTC that restrict certain practices in the collection of delinquent consumer debt, for example, practices related to late charges, responsibilities of cosigners, and wage assignments.

FRB, PURPOSES AND FUNCTIONS, *supra* note 276, at 80.

banking agencies—OCC, OTS, FDIC, and NCUA at the federal level, and by state banking agencies—that supervise these other institutions.²⁸⁸ Moreover, the federal banking agencies can use section 8 of the Federal Deposit Insurance Act to prevent unfair or deceptive acts or practices under section 5 of the Federal Trade Commission Act—“whether or not there is an FRB regulation defining the particular act or practice as unfair or deceptive.”²⁸⁹ The authority of the federal banking agencies is limited on one important dimension. Their supervisory powers are restricted to depository institutions—i.e., banks. This restriction proved especially problematic during the recent subprime debacle, as a majority of subprime lenders were nonbank mortgage brokers and finance companies.²⁹⁰ The Federal Reserve has the power, under TILA and HOEPA, to issue regulations binding upon *all* mortgage lenders. Only recently did the FRB propose to exercise these powers.²⁹¹ But even when the Federal Reserve issues such broad-reaching regulations, the federal banking agencies cannot enforce them on mortgage issuers that are not organized as banks.

²⁸⁸ See About the OCC, <http://www.occ.gov/aboutocc.htm> (last visited Oct. 1, 2008) (stating that the OCC enforces some consumer protection laws); FED. DEPOSIT INS. CORP., STRATEGIC PLAN 2005–2010 2 (2005), http://www.fdic.gov/about/strategic/strategic/strategic_plan05_10.pdf (listing the assurance that consumer rights are protected as one of the two strategic goals listed for the supervision program); see also Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1905 (Jan. 5, 2004) (“Part 34 of [the OCC’s] regulations implements 12 U.S.C. 371, which authorizes national banks to engage in real estate lending subject to ‘such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.’”). And one of the seven legal practice areas in the OCC Law Department is responsible for community and consumer law. See Office of the Comptroller of the Currency, Legal and Regulatory, <http://www.occ.gov/law.htm> (last visited Oct. 1, 2008) (“The Community and Consumer Law Division (CCL) provides legal interpretations and advice on consumer protection, fair lending and community reinvestment issues.”).

²⁸⁹ Julie L. Williams & Michael S. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 BUS. LAW. 1243, 1244 (2003); see also OCC Advisory Letter 2002-3, Guidance on Unfair or Deceptive Acts or Practices (Mar. 22, 2002), available at <http://www.occ.treas.gov/ftp/advisory/2002-3.doc> (advising national banks regarding practices constituting unfair or deceptive acts).

²⁹⁰ Greg Ip & Damian Paletta, *Regulators Scrutinized in Mortgage Meltdown*, WALL ST. J., Mar. 22, 2007, at A1 (finding that in 2005, 23% of subprime mortgages were issued by regulated thrifts and banks, another 25% were issued by bank holding companies, which were subject to different regulatory oversight through the federal system, and 52% “originated [with] companies with no federal supervision, primarily mortgage brokers and stand-alone finance companies”).

²⁹¹ See Truth in Lending, 73 Fed. Reg. 1672, 1672-73 (Jan. 9, 2008) (codified at 12 C.F.R. pt. 226) (regulating all lenders of mortgages secured by principal dwellings).

In theory, the banking agencies have authority to investigate new products, to develop new regulations, and to police those new regulations. The relevance of such power, however, is diminished by the agencies' lack of interest in exercising this power. The problem is not one of immediate politics or a particular party in government. The problem is deep and systemic. These agencies are designed with a primary mission to protect the safety and soundness of the banking system. This means protecting banks' profitability.²⁹² Consumer protection is, at best, a lesser priority that consists largely of enforcing Truth-in-Lending disclosure rules.²⁹³ The closer alignment of banking

²⁹² A broad interpretation of "safety and soundness," however, can include consumer protection on the theory that unsafe credit products can lead to consumer default. See, e.g., Schooner, *supra* note 283, at 62-63 ("The primary argument in favor of vesting federal bank regulators with responsibility for implementing consumer protection laws is the inherent overlap between consumer protection and prudential regulation. For example, a bank that is involved in predatory lending practices not only harms consumers by charging undisclosed fees, but also may threaten the bank's financial condition by systematically making overly risky loans."); John D. Hawkes, Comptroller of the Currency, Remarks Before the Women in Housing and Finance (Feb. 12, 2002), available at <http://www.occ.treas.gov/ftp/release/2002-10a.doc> (cautioning that government regulation inevitably entails burdensome costs).

²⁹³ The Federal Reserve describes its duties as falling into four general areas:

[1] [C]onducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates; [2] supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers; [3] maintaining the stability of the financial system and containing systemic risk that may arise in financial markets; [4] providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.

Fed. Reserve Bd., FRB: Mission, <http://www.federalreserve.gov/generalinfo/mission/default.htm> (last visited Oct. 1, 2008). The Federal Reserve does not view consumer protection as its core mission. As one scholar explained, "the Federal Reserve's . . . regulatory role remains focused on safety and soundness and not on other goals of financial regulation, such as consumer protection." Heidi Mandanis Schooner, *The Role of Central Banks in Bank Supervision in the United States and the United Kingdom*, 28 BROOK. J. OF INT'L L. 411, 427 (2003). Like the Federal Reserve, the OCC's core mission is "[e]nsuring a Safe and Sound National Banking System for All Americans." OCC, Administrator of National Banks, <http://www.occ.gov> (last visited Oct. 1, 2008). The OTS's core mission is "to ensure a safe and sound thrift industry," and it allocates the bulk of its resources to this mission. See OFFICE OF THRIFT SUPERVISION, STRATEGIC PLAN (2003-2008), at 3 (2003), available at <http://files.ots.treas.gov/480008.pdf>. Nevertheless, the OTS lists "fair access to financial services and fair treatment of thrift customers" among its other strategic goals. OFFICE OF THRIFT SUPERVISION, OMB FY2006 BUDGET/PERFORMANCE PLAN SUBMISSION 3, 6 (2006), available at <http://www.ots.treas.gov/docs/4/480030.pdf>. OTS lists among its priorities to "[c]onduct safety and soundness examinations of savings associations every 12-18

regulators with the banking industry than with banking customers is most obvious in cases where the interests of banks and consumers collide.

A recent example of such conflict was the intervention of the OCC in a dispute in California. The state legislature passed a law requiring credit card companies to reveal how long a customer would have to make minimum payments on a card before the balance would be paid in full and how much interest the customer would pay in the meantime. After the law was enacted, banks sued to enjoin enforcement. The OCC intervened—on the part of the banks. The OCC took the position that only the OCC could impose such requirements on the banks.²⁹⁴ Because the OCC had not imposed any such obligations on the banks, it took the position that “no regulation” was the OCC’s regulatory stance—and it warned the states off. Ultimately, the district court backed up the OCC. The California example is not unique. Former New York Attorney General Eliot Spitzer stated that the OCC “is actively engaged in undercutting the role of state regulators in ensuring that banks fairly serve the needs of all customers.”²⁹⁵

months that also incorporate an assessment of compliance with consumer-protection laws and regulations,” and to “address[] unfair or deceptive practices of regulated savings associations and promote[] fair access to financial services for all Americans and fair treatment of customers.” *Id.* at 6-7. As with other banking agencies, consumer protection is not the main focus of the FDIC. The FDIC identifies three major program areas: insurance, supervision, and receivership management. FED. DEPOSIT INS. CORP., *supra* note 288. Finally, the NCUA enforces existing consumer protection laws but focuses on safety and soundness of credit unions. See NCUA Compliance Self-Assessment Guide, <http://www.ncua.gov/GuidesManuals/ConsumerCompliance/ConsumerCompliance.htm> (last visited Oct. 1, 2008) (providing guidance for self-assessment of credit union boards); see also Press Release, Nat’l Credit Union Admin., NCUA Emphasizes Consumer Protection at Event on Capitol Hill (Feb. 9, 2007), *available at* http://www.ncua.gov/news/press_releases/2007/MA07-0209.htm.

²⁹⁴ See Brief for the Office of the Comptroller of the Currency as Amicus Curiae Supporting Plaintiffs, *Am. Bankers Ass’n v. Lockyer*, 239 F. Supp. 2d 1000 (E.D. Cal. 2002) (No. 02-1138) (describing the OCC’s statutory authority and recent case law invalidating state laws restrictive of national banks). As the *Lockyer* court stated,

courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws.

239 F. Supp. 2d at 1013 (quoting *NationsBank of N.C. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 256-57 (1995)).

²⁹⁵ Eliot Spitzer, Att’y Gen., N.Y. Att’y Gen. Office, Testimony Before the Assembly Standing Committee on Banks Regarding the Office of the Comptroller of the Currency’s Preemption of State Consumer Protection Laws (Apr. 16, 2004), *available at* <http://householdwatch.com/wp/2004/09/02/testimony-of-eliot-spitzer-regarding-the-occ>.

More generally, in 2004, the OCC issued regulations preempting the application of many state laws, including many consumer protection laws.²⁹⁶ The OCC, when intervening to prevent state consumer protection efforts, invokes the idea of a national banking system and the threat of inconsistent state regulations.²⁹⁷ If the OCC were more concerned with inconsistent regulations than with protecting banks' interests, it would step in and issue its own consumer protection regulations—applicable across the country. So far, this has not happened.²⁹⁸ As Professor Wilmarth noted in his testimony before Con-

²⁹⁶ See *supra* Part II.A.2.a; see also Bank Activities and Operations; Real Estate Lending and Appraisals, *supra* note 288, at 1905-06 (clarifying preemption of state law with respect to the OCC); Furletti, *supra* note 259, at 426 (examining “regulatory consequences of the NBA’s near total preemption of state statutes designed to protect credit card consumers” in which the NBA was used by the OCC to effect this broad preemption); Schooner, *supra* note 283, at 46 (noting that OCC issued regulations that sought to preempt state laws “despite much criticism”).

²⁹⁷ See, e.g., Bank Activities and Operations: Real Estate Lending and Appraisals, 69 Fed. Reg. at 1907-08 (asserting the need for preemption because “[m]arkets for credit (both consumer and commercial) . . . are now national, if not international, in scope,” and “the elimination of legal and other barriers to interstate banking . . . has led a number of banking organizations to operate . . . on a multi-state or nationwide basis”). “The agency therefore regards it as imperative that national banks be ‘enable[d] . . . to operate to the full extent of their powers under Federal law, without interference from inconsistent state laws, consistent with the national character of the national banking system’” Keith R. Fisher, *Toward a Basal Tenth Amendment: A Riposte to National Bank Preemption of State Consumer Protection Laws*, 29 HARV. J. L. & PUB. POL’Y 981, 995-96 (2006) (quoting Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. at 1908); see also Lockyer, 239 F. Supp. 2d at 1012-13, 1016 (explaining that the OCC “is responsible for administration of the [NBA],” where the fundamental purpose of the NBA is to “establish a national banking system free from intrusive state regulation,” and also concluding that the “national banks’ authority is not normally limited by, but rather ordinarily preempts contrary state law” (citing *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25, 32, 34 (1996))); Fisher, *supra*, at 995-96 (examining the justification for preemption as presented in the OCC’s regulations); Schooner, *supra* note 283, at 46 (“National banks applaud the OCC’s policy as allowing them the opportunity to operate under a single federal legal standard as opposed to varied state standards.”); Letter from Stephen I. Zeisel, Senior Counsel, & Ralph J. Rohner, Special Counsel, Consumer Bankers Ass’n, to John D. Hawke, Jr., Comptroller of the Currency 1 (Oct. 3, 2003) available at <http://www.cbanet.org/files/FileDownloads/OCCPreemption.pdf> (“[N]ational banks must be able to exercise the full range of federally established banking functions, without interference or burden from state regulatory and visitorial regimes.”).

²⁹⁸ See Wilmarth Testimony, *supra* note 259, at 76-83 (attesting to the failure of OCC to protect consumers); Rules, Policies, and Procedures for Corporate Activities; Bank Activities and Operations; Real Estate Lending and Appraisals, 68 Fed. Reg. 6161, 6376 (Feb. 7, 2003) (to be codified at 12 C.F.R. pts. 7, 34) (stating that national banks are subject to OCC regulation); see also Fisher, *supra* note 297, at 985-86 (“OCC contests the authority of state law enforcement officials to commence litigation to enforce compliance with state laws and with those federal laws that Congress has empowered

gress, “[s]ince January 1, 1995, the OCC has not issued a public enforcement order against any of the eight largest national banks” and has only issued thirteen orders against national banks for violating consumer lending laws.²⁹⁹ In contrast, “[d]uring 2003 alone, state officials initiated more than 20,000 investigations . . . [,] took more than 4,000 enforcement actions in response to consumer complaints about abusive lending practices,” and held lenders accountable to the tune of \$1 billion in penalties and restitution.³⁰⁰

The OCC’s inaction may also be attributable, at least in part, to its direct financial stake in keeping its bank clients happy. Large national banks fund a significant portion of the OCC’s budget. Assessments comprise 95% of the OCC’s budget, with the twenty largest national banks covering nearly three-fifths of these assessments. The

state officials to enforce, even where OCC itself has declined to act.”). Furthermore, Fisher notes that

[t]he only actual regulatory prohibitions that OCC has promulgated are against making real estate loans “based predominantly on the bank’s realization of the foreclosure or liquidation value of the borrower’s collateral, without regard to the borrower’s ability to repay the loan according to its terms” (that is, prohibiting equity stripping), and against engaging in “unfair or deceptive trade practices within the meaning of section 5 of the Federal Trade Commission Act” and the implementing regulations of the FTC. The latter is rather a hollow gesture given that, as OCC freely admits, it took OCC and the other federal banking agencies “more than twenty-five years to reach consensus on their authority to enforce the FTC Act.”

Id. at 992-93 (footnotes omitted).

²⁹⁹ Wilmarth Testimony, *supra* note 259, at 77-78. Two of these orders probably resulted only due to indirect pressures exerted by other federal agencies. *Id.*

³⁰⁰ *Id.* at 79. These actions have attempted to stop “a wide variety of abusive practices . . . such as predatory lending, privacy violations, telemarketing scams, biased investment analysis, and manipulative initial public offerings.” *Id.* at 78. In many of these cases, the OCC filed amicus briefs in support of the banks arguing for the preemption of states’ consumer protection laws. *Id.* Other commentators confirm this as well:

In response to a 2005 Freedom of Information Act request, the OCC reported that its “customer assistance group” employed a grand total of three people whose job primarily involved investigating and resolving consumer complaints. By comparison, according to a fact sheet from the House Financial Services Committee, state banking agencies and [attorneys general’s] offices employ nearly 700 full-time examiners and attorneys who make sure that consumer laws are enforced. In 2003 alone, state bank agencies brought 4,035 consumer enforcement actions. Since 2000, the OCC has brought just 11 consumer enforcement actions. The biggest two involved cases that were initiated and investigated by state attorneys general and that the OCC initially tried to prevent from going forward.

Stephanie Mencimer, *No Account: The Nefarious Bureaucrat Who’s Helping Banks Rip You Off*, NEW REPUBLIC, August 27, 2007, at 14, 14-15.

OCC's ability to attract large banks to the national banking system results in a significant financial gain. During 2004–2005, the charter conversions of three large, national banks—JP Morgan Chase, HSBC, and Bank of Montreal—resulted in the transfer of \$1 trillion of banking assets into the OCC's jurisdiction. This transfer alone raised OCC's assessment revenues by 15%.³⁰¹ Moreover, the greater the stability of OCC institutions, the more influence the agency has. By attracting more financial-services companies to incorporate as federally chartered banks under the supervision of the OCC, the agency can expand its influence. Accordingly, the OCC would be reluctant to impose substantial constraints on banks, fearing that such constraints might induce the banks to switch to a competing regulator.

The lack of interest and incentives to address consumer protection issues is not limited to the OCC. Recently, the Federal Reserve has come under congressional scrutiny for failing to exercise its rule-making authority to protect consumers.³⁰² In response to well-publicized pressure from Congress,³⁰³ the Federal Reserve and the OCC have begun to address some of the consumer protection problems associated with consumer credit products, specifically credit cards³⁰⁴ and subprime mortgage loans.³⁰⁵ But the agencies' long history of inaction in the consumer credit markets suggests that the

³⁰¹ See Wilmarth Testimony, *supra* note 259, at 17.

³⁰² *Improving Federal Consumer Protection in Financial Services: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 37-38 (2007) (statement of Rep. Frank) [hereinafter Frank Statement] (“[I]f the Fed doesn’t start to use that authority to roll out the rules, then we will give it to somebody who will use it.”).

³⁰³ See John Poirier, *Lawmaker Tells Fed to Step Up Consumer Protection*, REUTERS, June 13, 2007, <http://www.reuters.com/article/businessNews/idUSN1339842620070613> (quoting Frank Statement, *supra* note 302).

³⁰⁴ See *supra* note 132 (discussing potential changes by the FRB); see also Consumer Protection Hearing, *supra* note 49, at 15-16 (advocating to Congress that current credit card disclosure rules should be changed to improve consumers’ ability to make well-informed decisions). In response, the FRB and the OCC are revising the disclosure regulations under TILA. See Press Release, Fed. Reserve Bd., *supra* note 51 (“The [proposed] provisions . . . follow the Board’s 2007 proposal to improve the credit card disclosures under [TILA].”).

³⁰⁵ See Truth in Lending, 73 Fed. Reg. 1672 (proposed Jan. 9, 2008) (to be codified at 12 C.F.R. pt. 226) (providing new protections for high-price mortgages secured by a consumer’s dwelling). The Fed and the other banking agencies became aware of questionable lending practices in the subprime mortgage market in 2004. Yet they took no action until September 2006 and even then issued only a “guidance” that addressed only exotic mortgage products (e.g., Option ARMs) to the exclusion of most subprime loans. A broader “guidance” was issued only in June 2007. And binding rules were not proposed until January 2008. See generally Edmund L. Andrews, *Fed and Regulators Shrugged as Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, at A1.

agencies lack the interest or willingness to dedicate the resources needed to create effective consumer protection.

ii. The FTC: Motivation Without Authority

Consumer credit products are also regulated by the Federal Trade Commission (FTC). While consumer protection is generally of secondary importance to banking agencies, one of the central missions of the FTC is consumer protection.³⁰⁶ But the FTC's consumer protection activities span many different categories of consumer products, leaving only limited resources for consumer credit products.³⁰⁷ More importantly, the FTC lacks authority over banks and other depository institutions, and thus cannot effectively regulate consumer credit products. The FTC Act specifically excludes banks from FTC supervision.³⁰⁸ Even the hallmark FTC mandate—to prevent unfair and deceptive acts and practices³⁰⁹—cannot be enforced by the FTC when the actors are financial institutions.³¹⁰ Instead, if the FTC found that a bank engaged in unfair or deceptive acts, it would have to turn to the banking agencies to deal with the problem. Moreover, the FTC Improvement Act of 1975 gave the Federal Reserve—not the FTC—the authority to define what constitutes unfair and deceptive acts and practices by a financial institution.³¹¹

This is not to say that the FTC has no authority over consumer credit products. The FTC assures compliance by nondepository entities with a variety of statutory provisions under TILA³¹² and other

³⁰⁶ See FTC—About Us, <http://www.ftc.gov/ftc/about.shtm> (last visited Oct. 1, 2008) (summarizing the mission of the FTC to both protect consumers and promote fair competition).

³⁰⁷ See FTC, Legal Resources—Statutes Relating to Consumer Protection Mission, <http://www.ftc.gov/ogc/stat3.shtm> (last visited Oct. 1, 2008) (describing the many different statutes the FTC implements); FTC, Commission Actions for December 2007, <http://www.ftc.gov/os/2007/12/index.shtm> (last visited Oct. 1, 2008) (describing how during a single month in 2007, the FTC was involved in actions pertaining to rental car issuers, marketers of medical bracelets, and the Multiple Listing Service for selling homes).

³⁰⁸ Federal Trade Commission Act, 15 U.S.C. §§ 41–58 (2006).

³⁰⁹ *Id.* § 45.

³¹⁰ Williams & Bylsma, *supra* note 289, at 1244–45. The FTC does have authority over nonbank lenders, however. For example, many mortgage companies fall into this category.

³¹¹ *Id.* at 1244.

³¹² “These provisions include mandatory disclosures concerning all finance charges and related aspects of credit transactions, requirements for advertisers of credit terms, and a required three-day right of rescission in certain transactions involv-

credit laws.³¹³ The FTC also regulates mandatory disclosures by non-federally insured depository institutions, under the Federal Deposit Insurance Corporation Improvement Act of 1991.³¹⁴ In addition, the FTC performs some other credit-related functions: it combats identity theft, which is often related to consumer credit products;³¹⁵ it enforces statutory limits on debt collection practices;³¹⁶ it exercises some oversight over “credit repair” services, prohibiting untrue or misleading

ing the establishment of a security interest in the consumer’s residence.” FTC, *supra* note 307; *see also* Truth in Lending Act, 15 U.S.C. §§ 1601–1613, 1631–1649, 1661–1667f (2006). The description of this law, as well as the descriptions of other laws in the text and notes below, are taken from FTC, *supra* note 307.

³¹³ See Fair Credit Billing Act, 15 U.S.C. §§ 1666–1666j (2006) (requiring prompt written acknowledgment of consumer billing complaints and investigation of billing errors by creditors, prohibiting creditors from taking actions that adversely affect the consumer’s credit standing until an investigation is completed, and requiring that creditors promptly post payments to the consumer’s account and either refund overpayments or credit them to the consumer’s account); §§ 1637a, 1647, 1665b (implementing provisions of the Home Equity Loan Consumer Protection Act of 1988 by requiring creditors to provide certain disclosures for open-end credit plans secured by the consumer’s dwelling and imposing substantive limitations on such plans); Home Ownership and Equity Protection Act, 15 U.S.C. § 1639 (establishing disclosure requirements and prohibiting equity stripping and other abusive practices in connection with high-cost mortgages); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C.) (requiring certain creditors to disclose on the front of billing statements a minimum monthly payment warning for consumers and a toll-free telephone number, established and maintained by the Commission, for consumers seeking information on the time required to repay specific credit balances); Fair Credit and Charge Card Disclosure Act of 1988, Pub. L. 100-583, 102 Stat. 2960 (codified as amended in scattered sections of 15 U.S.C.) (requiring credit and charge card issuers to provide certain disclosures in direct mail, telephone, and other applications and solicitations to open-end credit and charge accounts and under other circumstances); Consumer Leasing Act, 15 U.S.C. §§ 1667–1667f (regulating personal property leases that exceed 4 months in duration and that are made to consumers for personal, family, or household purposes, imposing limitations on the size of penalties for delinquency or default and on the size of residual liabilities, and requiring certain disclosures in lease advertising). The preceding descriptions of acts are quoted from FTC, *supra* note 307.

³¹⁴ 12 U.S.C. § 1831t (2006) (charging the FTC with enforcement of audit and disclosure requirements for depository institutions lacking federal deposit insurance).

³¹⁵ See Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 117 Stat. 1952 (codified as amended in scattered sections of 15 and 20 U.S.C.) (amending the Fair Credit Reporting Act) (giving consumers access to credit information in addition to providing for mitigation of the likelihood and harm of identity theft); Identity Theft Assumption and Deterrence Act of 1998, Pub. L. No. 105-318, 112 Stat. 3007 (codified as amended at 18 U.S.C. § 1028 (2006)) (establishing the FTC as the agency responsible for identity-theft claims).

³¹⁶ See Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692–1692p (2006).

representations and requiring certain affirmative disclosures;³¹⁷ it protects consumers' privacy rights against financial institutions and credit bureaus that collect consumer information by ensuring the accuracy of the collected information;³¹⁸ and it enforces antidiscrimination laws in the consumer credit context.³¹⁹ Beyond the implementation and enforcement of these specific statutes, the FTC enjoys general authority to prevent unfair and deceptive trade practices and, in particular, to prevent unfair advertising practices—but not in depository institutions.³²⁰ In other words, credit cards and mortgages issued by banks or thrifts are exempt from the reach of the FTC.³²¹

This litany of agencies, limits on rulemaking authority, and divided enforcement powers results in inaction. No single agency is charged with supervision over any single credit product that is sold to the public. No single agency is charged with the task of developing expertise or is given the resources to devote to enforcement of consumer protection. No single agency has an institutional history of protecting consumers and assuring the safety of products sold to them.³²²

³¹⁷ See Credit Repair Organizations Act, 15 U.S.C. §§ 1679–1679j (2006) (prohibiting deceptive and abusive tactics for the collection of debts incurred from personal, family, or household expenditures).

³¹⁸ See Financial Services Modernization Act of 1999 (codified at 15 U.S.C. §§ 6801–6809, 6821–6827 (2006)) (requiring financial institutions to have privacy policies in place to protect data integrity); Fair Credit Reporting Act, 15 U.S.C. §§ 1681–1681(u) (2006) (setting requirements for creditors providing information to credit reporting agencies to ensure accuracy); Fair and Accurate Credit Transactions Act of 2003, 15 U.S.C. §§ 1681–1681x (2006) (amending the Fair Credit Reporting Act) (providing free annual credit reports for consumers from three major credit reporting agencies).

³¹⁹ Equal Credit Opportunity Act, 15 U.S.C. §§ 1691–1691f (2006).

³²⁰ See 15 U.S.C. §§ 45(a)(2), 57a(f) (2006).

³²¹ See Letter from Donald S. Clark, Sec'y, FTC, to Jennifer L. Johnson, Sec'y, Bd. of Governors of the Fed. Reserve Sys., at 1 (Sep. 14, 2006), *available at* http://www.federalreserve.gov/SECRS/2006/November/20061121/OP-1253/OP-1253_53_1.pdf (describing the authority of the FTC and noting the FTC's "wide-ranging responsibilities regarding consumer financial issues for most nonbank segments of the economy").

³²² As Henry Paulson, Secretary of the Treasury, remarked,

our complex and fragmented regulatory system complicates an already difficult situation. Existing federal laws address mortgage fraud, disclosures, fair lending, unfair and deceptive practices, and other aspects of the mortgage process. But the regulatory and enforcement authority varies across different federal agencies. States have also enacted an additional layer of regulation, typically applied only to certain institutions that operate within that state and enforced by the state agencies.

B. *A New Proposal*

Learning from the strengths and, more importantly, from the shortcomings of current solutions, it is possible to sketch the outlines of a more effective regulatory response to the identified failures in consumer credit markets. We propose the creation of a single federal regulator—a new Financial Product Safety Commission or a new consumer credit division within an existing agency (most likely the FRB or FTC)—that will be put in charge of consumer credit products. Our proposed regulatory framework has three critical elements: (1) *ex ante* regulation, rather than *ex post* judicial scrutiny; (2) regulation by an administrative agency with a broad mandate, rather than by specifically targeted piecemeal legislation; and (3) entrusting the authority over consumer credit products to a single, highly motivated federal regulator, such that the same regulation applies to all similar products, regardless of the identity of the lender.³²³

First, the proposed solution adopts an *ex ante* approach. The regulation of consumer credit markets is not amenable to *ex post* judicial review. While extreme practices may be policed using the unconscionability doctrine or other common law doctrines, these tools are too blunt to provide a comprehensive regulatory response to unsafe consumer credit products. The proposed regulator will develop expertise that will enable it to promulgate nuanced regulations that account for product innovation.³²⁴

This patchwork structure should be streamlined and modernized.

Henry M. Paulsen, Jr., Sec'y, U.S. Treasury, Remarks at the Georgetown University Law Center on Current Housing and Mortgage Market Developments (Oct. 16, 2007), available at <http://www.treasury.gov/press/releases/hp612.htm>.

³²³ A different approach would reverse the preemption trend and restore state authority over consumer credit products. This approach would also have to reverse the exportation doctrine in order to avoid a race to the bottom. But empowering the states would come at a cost. First, not all states will be equally motivated to regulate consumer credit products (perhaps due to regulatory capture in certain states). Second, not all states will be equally effective in regulating consumer credit products—e.g., resources, at least in some states, will be significantly more modest than federal resources. Finally, state-level regulation will potentially expose national lenders to fifty different regulatory regimes. For these reasons, we believe that an optimally designed regulatory framework at the federal level is superior to state-level regulation. We recognize, however, that a comprehensive comparison between the federal- and state-level solutions is much more complicated, and we defer such a comparison for future research.

³²⁴ These regulations can be enforced either via *ex ante* inspection or via *ex post* litigation. Our main point is that common law courts should not be setting the standards *ex post* as a by-product of specific case resolution.

Second, we propose that the *ex ante* regulations be promulgated and enforced by an administrative agency with broad rulemaking and enforcement authority over consumer credit products. Legislation targeted to specific practices, with narrowly defined authority delegated to administrative agencies, is incapable of effectively responding to the high rate of innovation in consumer credit markets and the subtle ways in which creditors can exploit consumer misunderstanding. An administrative agency with a broad mandate could develop more institutional expertise and quicker responses to new products and practices.³²⁵

Third, we propose to regulate consumer financial products, much in the same way that manufactured products—meat, agricultural products, drugs, cosmetics, and a host of other physical products—are regulated: regulation follows the product, not the manufacturer. Regardless of who issues the product, a single federal regulator will oversee the design and dissemination of the product. This approach will eliminate regulatory gaps and contradictions, and it will halt the state and federal regulatory competition that undercuts consumer safety. In this respect our proposal has much in common with the Conduct of Business Regulatory Agency (CBRA) envisioned in Secretary Paulson’s “Blueprint for a Modernized Financial Regulatory Structure.”³²⁶ Paulson proposes the establishment of a single federal regulator that will “be responsible for business conduct regulation across all types of financial firms.”³²⁷

³²⁵ A possible concern about concentrating authority in a single regulator is that it could exacerbate the problem of political capture. It is not clear that diffuse authority is less prone to regulatory capture than concentrated authority. For example, consumer groups find it difficult to oppose well-funded banking interests at multiple state legislatures, and they may be better able to serve as an effective counterweight at a single federal regulator. In any event, minimizing the risk of capture is a main regulatory-design challenge in implementing our proposal.

³²⁶ See U.S. DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 170-74 (2008), *available at* <http://www.treas.gov/press/releases/reports/Blueprint.pdf> (proposing a single “business conduct regulator” to protect customers of financial institutions).

³²⁷ *Id.* at 171. More fully, Paulson suggests that

a new business conduct regulator, CBRA, should be created. CBRA should be responsible for business conduct regulation *across all types of financial firms*. As described above, business conduct regulation in the optimal framework includes the regulation of key aspects of consumer protection such as disclosures, business practices, and chartering and licensing. CBRA should be responsible for implementing uniform national business conduct standards in these areas.

We recognize that concentrated, broad authority in itself will not guarantee adequate protection for consumers. To be effective, authority must be coupled with motivation to exercise that authority. An agency that views its core mission as ensuring the safety and soundness of banks might not dedicate sufficient resources to consumer protection even if it has complete authority to regulate the safety of consumer credit products. In implementing our proposal, a central challenge will be the design of enabling legislation that provides this crucial combination of authority and motivation.³²⁸

CONCLUSION

The market for consumer credit is not operating efficiently. Evidence abounds that consumers are sold credit products that are designed to obscure their risks and to exploit consumer misunderstanding. Ordinary market mechanisms, such as competition and expert advisers, cannot fully correct these deficiencies. Without regulatory intervention, market distortions and inefficiencies will continue to grow, imposing substantial costs on American families and on the economy.

Minimum product safety standards are carefully regulated for nearly all physical products. Such standards are, however, noticeably absent in the regulations of credit products. Ex post regulation by litigation is a weak tool, and the contradictory patchwork of state and federal ex ante regulations has proven itself ineffective to protect consumers. The flaws in the current system are not simply the shortcomings of particular legislators or regulators. Instead, the entire framework of credit product regulation is deeply flawed.

The failure of current attempts at regulation of credit-product safety prompts us to propose the creation of a new federal regulator—a Financial Product Safety Commission or a new consumer credit divi-

Id. (emphasis added). The Paulson proposal to consolidate authority in CBRA is motivated by the shortcomings of the current regulatory structure—shortcomings that are similar to those described earlier in Part II.A. *Id.* at 172 (“The current multi-agency business conduct oversight structure creates uneven enforcement, potential enforcement gaps, disputes over jurisdiction, and regulatory inconsistency.”).

³²⁸ Congressman Frank has raised the possibility of entrusting the FTC with authority over consumer credit products. See Frank Statement, *supra* note 302. Similarly, the Center for Responsible Lending, noting the FRB’s failure to exercise its authority under HOEPA, proposed that Congress give parallel authority to the FTC. See *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before the S. Comm. on Banking, Housing & Urban Development*, 110th Cong. (2007) (testimony of Mark Eakes, CEO, Ctr. for Responsible Lending & Ctr. for Self-Help).

sion within an existing agency (the FRB or FTC). We do not lay out every aspect of such a regulatory body—indeed, we invite those more deeply schooled in administrative law and other disciplines to help fill in the picture of how such a regulator can be optimally structured. We can, however, identify three features that will enable this regulator to make markets function better for consumers: reliance on ex ante regulation rather than ex post litigation, rulemaking located with a regulatory agency rather than a legislature, and regulation based on the product sold rather than the identity of the seller. These three features would go a long distance toward restoring a functioning market for credit that is based on wealth-enhancing transactions for both consumer and seller.